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THE COSTS OF FOREIGN DEBT FOR THE UNITED STATES AND THE THIRD WORLD

HEARINGS

BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

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THE UNITED STATES AS A DEBTOR NATION

THURSDAY, JUNE 20, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ECONOMIC STABILIZATION,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2220, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Representatives LaFalce, Cooper, Erdreich, Shumway, and Wortley.

Chairman LAFALCE. The Subcommittee on Economic Stabilization will come to order.

Our subcommittee has been holding a series of hearings on the challenges posed by the growing integration of the U.S. economy into the world economy.

Prior hearings have examined the uncompetitive dollar, the trade deficit, trade friction with Japan, and the need to improve specific industries' competitiveness.

At today's hearing and three hearings next month, we will consider the relationship between our deteriorating international accounts and the slowdown of the domestic economy.

The average length of the expansion phase of the business cycle is 33 months. The current business cycle's expansion began almost that long ago. The goods-producing sector, which is most affected by the high dollar, is showing more and more signs of weakness.

The Department of Commerce issued figures this week that officially confirm that the United States became a debtor nation in March of this year. For the hearing today, we have asked our witnesses to discuss the implications of our rapidly declining international investment position.

On the face of it, it seems absurd for the United States to be a debtor nation. Surely, we are one of the richest nations on Earth. Only a tiny minority of the rest of the world's population of 4 billion people can even approach our overall level of productivity, standard of living, or accumulated wealth and resources.

A rich nation such as ours should be providing capital to the rest of the poor, capital-starved world. But, for the last few years, we have been borrowing to the hilt and living beyond our means. We have become like the grasshopper of Aesop's fables that consumed everything in sight with no thought for tomorrow.

Until recently, our international economic performance more resembled the thrifty ant. From World War I until 1982, the United

States was gradually building up its assets abroad faster than foreigners were investing here.

At the end of 1982, the United States had the strongest financial position of any nation on Earth. Americans owned \$838.1 billion worth of investments abroad, while foreigners owned \$688.6 billion in investments here.

In effect, the United States has taken barely 2 years to squander the \$150 billion nest egg that it had taken almost 70 years to accumulate. We continue to go deeper into hock to the rest of the world at an annual rate of more than \$100 billion a year.

According to the Congressional Research Service, a consensus of major economic forecasters indicates that the United States could be in debt to the rest of the world by \$351 billion by the end of 1987.

If these forecasts hold, our Nation's position in world financial markets could plummet from a positive \$150 billion in 1982 to a minus \$351 billion by 1987. That is a swing of \$501 billion in 5 short years.

These developments on the capital end of our international accounts have much to do with the value of the dollar and our Nation's current trade problems. In effect, our Nation is paying for a growing volume of imports by exporting assets rather than goods.

As foreigners have converted their own currencies into dollars to buy U.S. investments, they have raised the value of the dollar. In the absence of foreigners' demand for the dollar to invest here, a growing trade deficit would have reduced the value of the dollar.

In the words of Fed Chairman Volcker, the U.S. economy has become "hooked" on larger and larger doses of foreign capital. How important are these foreign funds to keeping our capital markets and production going?

Can the monetary authorities reduce interest rates to spur the domestic economy but still keep them high enough to continue to attract foreign funds? Can the United States gradually wean itself away from annual infusions of \$100 billion in foreign capital?

For the longer term, it is obvious that we cannot achieve more stable exchange rates unless we have more stable capital flows. What should be done to stabilize international capital flows with the goal of more stable exchange rates?

With its typical blind eye toward serious economic problems, the administration dismisses the argument that the trends in our international accounts threaten the health of the economy.

It contends that the flow of capital to the United States simply represents world confidence in the wisdom of its economic policies. For example, at a press conference a few months ago, President Reagan rejected the notion that the dollar was overvalued. He recommended that other countries follow his policies so that they would see their currencies rise in value, too.

The evidence refutes that administration argument. Foreign investors have been attracted by high interest rates. Those interest rates are largely due to our budget deficits, coupled with inflation-fighting monetary policy.

Foreigners are mostly investing in interest-bearing assets like Government securities, corporate bonds, and bank deposits, not in profit-earning corporate stocks.

In fact, last year as foreigners extended an additional \$100 billion to the United States, they actually reduced their portfolio holdings of corporate stocks by \$3 billion.

Today, we are fortunate to have two of the most eloquent and outspoken experts on the deterioration of our international accounts. Martin Feldstein, professor of economics at Harvard University, former Chairman of the Council of Economic Advisers; and Fred Bergsten, director of the Institute for International Economics.

Gentlemen, we are very pleased and proud to have witnesses of your caliber before us on this extremely important issue; and second, how necessary it is to recess before we hear you, because the beckoning of the bells.

When the bells beckon, we respond. We will recess temporarily until 10:15.

[Recess.]

Chairman LAFALCE. The subcommittee will reconvene.

We will put the entire text of the testimony in the record of each witness, and you may feel free to read from it or to summarize as they desire.

Since we only have two witnesses, I am not going to put any constraints on the individuals, and you may take the time that you desire.

Dr. Feldstein.

STATEMENT OF MARTIN FELDSTEIN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. FELDSTEIN. Thank you very much, Mr. Chairman.

I am certainly pleased to be here this morning. I will read my statement.

During most of the years between World War II and the beginning of the present decade, the United States was a capital exporter. American individuals, financial institutions, and other businesses invested abroad and loaned funds to foreign borrowers. As a result, we developed a modest stock of overseas investments.

In the last few years, that has been dramatically reversed. In 1982, United States merchandise imports from abroad not only exceeded our export, but exceeded them by so much that we could not pay for the excess by our earnings from services and our income on overseas investments. As a result, we had to borrow about \$6 billion from the rest of the world.

That overseas borrowing, together with the sale of U.S. securities and assets to foreign investors, has grown dramatically in the past few years, as your opening statement indicated.

In 1984, the net inflow of foreign funds reached the unprecedented total of \$95 billion. This year, the net capital inflow will be even larger and may reach \$130 billion.

It is this exploding rate of capital inflow that has turned the United States into a debtor nation, according to conventional international accounting standards.

To put the magnitude of our recent capital inflow into perspective, you should note that 1984's capital inflow of \$95 billion was

enough to finance more than half of all of the borrowing by the Federal Government.

Even more startling, that foreign capital inflow was enough to finance more than 40 percent of the net investment in the United States in plant and equipment and in housing. In short, we have become very dependent on the inflow of capital from abroad to finance investment here in the United States.

I will return to the significance of that dependence in a moment. But first, I want to summarize the reasons why the United States has become a capital importer in the past few years.

The primary reason that the United States has become a capital importer and an international debtor is our vast Federal budget deficit. Budget deficits beget capital inflows. It is a universal story that explains the capital inflows of the Latin American debtor nations as well as our own capital inflow.

When the Government borrows on a vast scale, it creates a vacuum in the domestic capital market that sucks in capital from abroad.

The mechanism by which this capital inflow is achieved is now well understood. Massive current and projected Government borrowing has driven up the real interest rate on long-term U.S. Government and corporate bonds. The higher interest rate makes dollar-denominated bonds more attractive to investors both at home and abroad.

The increased demand for dollar securities causes the value of the dollar to rise relative to other currencies. The strong dollar results in an enlarged trade deficit. The capital inflow is the financial consequence of that enlarged trade deficit as we borrow and sell U.S. assets to pay for that trade deficit.

Although the rise in the U.S. budget deficit has been the primary reason for the increased capital inflow, it is not the only reason. Dollar securities have become more attractive because of the perception that American monetary policy will prevent a return to rapid inflation.

The 1981 changes in U.S. tax laws and the decline in inflation in the last few years have raised the real after-tax return on investments in plant and equipment in this country, and that has been translated into higher real rates of return on dollar securities.

And the special problems of the LDC debtor nations have made them less creditworthy and have reduced lending to those countries.

The most visible consequence of the increased capital inflow and the strong dollar has been the unprecedented trade deficit. That trade deficit has been hurting a wide range of American industries including agriculture and timber, basic industries like steel and chemicals, and even high technology firms.

As a result, the level of industrial production is actually lower now than it was last summer, and the level of manufacturing employment has been falling every month since the beginning of the year. Because of the strong dollar, the manufacturing sector of our economy has been in recession since the start of this year.

The capital inflow also has a favorable side, in the short term, at least. Because foreign capital is offsetting much of the Government borrowing, the level of real interest rates in the United States has

not risen as much as it might otherwise have done. And thanks to the foreign capital, investment has not been as depressed as it otherwise would have been.

But it would be wrong to say, as some do, that the capital inflow is not a problem because we have been using those funds to finance investment. I hear that frequently. I think it is a mistake.

While in an accounting sense the funds that are borrowed from abroad are used to finance investments in plant and equipment and in housing, in a more important sense the foreign capital is not being used to finance increased investment.

In reality, the foreign funds have been used to offset the massive Government borrowing. They have kept the level of investment from falling as low as it would have without those foreign funds.

But they have certainly not led to a correspondingly large rise in net investment in the United States relative to our own meager historic norm. The foreign capital inflow has financed government profligacy in the United States in the same way that the inflow of capital to the major debtor nations of Latin America has financed Government profligacy there.

The benefit of the capital inflow is, of course, only temporary. The borrowing that we as a nation are now doing must be repaid or serviced in the future. Because of our current profligacy, our children will not be able to keep all that they produce in the United States.

The risk of satiation:

We have become dependent on the inflow of capital from abroad to finance American investment in plant and equipment and in housing. At some point, foreign investors will become satiated with dollar securities.

As their accumulated investment in dollar securities increases, additional investments become more and more risky. When the risk of increased exposure outweighs the higher yield available on dollar securities, the foreign investors will reduce their demand for dollar securities.

The result will be a fall in the dollar and a decline in the capital inflow from abroad.

If the capital inflow shrinks while the U.S. Government is still borrowing as heavily, interest rates in the United States will rise and investment here will decline. The result could so unbalance the expansion that the economy is pushed into recession. And, over time, the low rate of investment will mean slower growth, inferior employment opportunities and lower incomes.

Our trade deficit and our dependence on foreign capital are dark clouds hanging over America's economic future. The key to bringing down the dollar in a healthy way and ending our dependence on foreign capital is to reduce the projected deficits in the Federal budget.

What matters is not just the deficit for next year but, even more important, the prospects for the deficit in 1987, 1988 and beyond. As the Congress moves forward to vote on a budget in the coming months, the opportunity to solve the critical problems that we are discussing this morning will be in your hands.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Feldstein follows:]

The United States as a Capital Importer

Martin Feldstein

Testimony to the
Committee on Banking, Finance and Urban Affairs
Subcommittee on Economic Stabilization
U.S. House of Representatives

June 20, 1985

Thank you, Mr. Chairman. I am pleased to appear before this committee and to participate in these hearings on "The U.S. as a Debtor Nation."

During most of the years between World War II and the beginning of the present decade, the United States was a capital exporter. American individuals, financial institutions and other businesses invested abroad and loaned funds to foreign borrowers. As a result, we developed a modest stock of overseas investments.

In the last few years that has been dramatically reversed. In 1982, U.S. merchandise imports from abroad not only exceeded our export but exceeded them by so much that we could not pay for the excess by our earnings from services and our income on overseas investments. As a result, we had to borrow about \$6 billion from the rest of the world.

That overseas borrowing, together with the sale of U.S. securities and assets to foreign investors, has grown dramatically in the past few years. In 1984, the net inflow of foreign funds reached the unprecedented total of \$95 billion. This year the net capital inflow will be even larger and may reach \$130 billion. It is this exploding rate of capital inflow that has turned the United States into a debtor nation according to conventional international accounting standards.

* Professor of Economics, Harvard University. Testimony before the House Committee on Banking, Finance and Urban Affairs, Subcommittee on Economic Stabilization, June 20, 1985.

To put the magnitude of our recent capital inflow into perspective, note that 1984's capital inflow of \$95 billion was enough to finance more than half of all of the borrowing by the federal government. Even more startling, that foreign capital inflow was enough to finance more than 40 percent of the net investment in the United States in plant and equipment and in housing. In short, we have become very dependent on the inflow of capital from abroad to finance investment here in the United States. I will return to the significance of that dependence in a moment. But first I want to discuss the reasons why the United States has become a capital importer in the past few years.

Why the U.S. is a Capital Importer

The primary reason that the United States has become a capital importer and an international debtor is our vast federal budget deficit. Budget deficits beget capital inflows. It is a universal story that explains the capital inflows of the Latin American debtor nations as well as our own capital inflow. When the government borrows on a vast scale, it creates a vacuum in the domestic capital market that sucks in capital from abroad.

The mechanism by which this capital inflow is achieved is now well understood. Massive current and projected government borrowing has driven up the real interest rate on long-term U.S. government and corporate bonds. The higher interest rate makes dollar-denominated bonds more attractive to investors both at home and abroad. The increased demand for dollar securities causes the value of the dollar to rise relative to other currencies. The strong dollar results in an enlarged trade deficit. The capital inflow is the financial consequence of that enlarged trade deficit as we borrow and sell U.S. assets to pay for that trade deficit.

Although the rise in the U.S. budget deficit has been the primary reason for the increased capital inflow, it is not the only reason. Dollar securities have become more attractive because of the perception that American monetary policy will prevent a return to rapid inflation. The 1981 changes in U.S. tax laws and the decline in inflation have raised the real after-tax return on investments in plant and equipment in this country and that has been translated into higher real rates of return on dollar securities. And the special problems of the LDC debtor nations have made them less creditworthy and have reduced lending to those countries.

Consequences of the Attracting Capital

The most visible consequence of the increased capital inflow and the strong dollar has been the unprecedented trade deficit. That trade deficit has been hurting a wide range of American industries including agriculture and timber, basic industries like steel and chemicals, and even high technology firms. As a result, the level of industrial production is actually lower now than it was last summer and the level of manufacturing employment has been falling every month since the beginning of the year. Because of the strong dollar, the manufacturing sector of our economy has been in recession since the start of this year.

The capital inflow also has a favorable side -- in the short-term at least. Because foreign capital is offsetting much of the government borrowing, the level of real interest rates in the United States has not risen as much as it might otherwise have done. And thanks to the foreign capital, investment has not been as depressed as it otherwise would have been.

But it would be wrong to say that the capital inflow is not a problem because we have been using those funds to finance investment. While in an accounting sense the funds that are borrowed from abroad are used to finance investments in plant and equipment and in housing, in a more important sense the foreign capital is not being used to finance increased investment. In reality, the foreign funds have been used to offset the massive government borrowing. They have kept the level of investment from falling as low as it would have without those foreign funds. But they have certainly not led to a correspondingly large rise in net investment in the United States relative to our own meager historic norm. The foreign capital inflow has financed government profligacy in the United States in the same way that the inflow of capital to the major debtor nations of Latin America has financed government profligacy there.

The benefit of the capital inflow is of course only temporary. The borrowing that we as a nation are now doing must be repaid or serviced in the future. Because of our current profligacy, our children will not be able to keep all that they produce in the United States.

The Risk of Satiation

We have become dependent on the inflow of capital from abroad to finance American investment in plant and equipment and in housing. At some point, foreign investors will become satiated with dollar securities. As their accumulated investment in dollar securities increases, additional investments become more and more risky. When the risk of increased exposure outweighs the higher yield available on dollar securities, the foreign investors will reduce their demand for dollar securities. The result will be a fall in the dollar and a decline in the capital inflow from abroad.

If the capital inflow shrinks while the U.S. government is still borrowing as heavily, interest rates in the United States will rise and investment here will decline. The result could so unbalance the expansion that the economy is pushed into recession. And, over time, the low rate of investment will mean slower growth, inferior employment opportunities and lower incomes.

Reducing the Budget Deficit

Our trade deficit and our dependence on foreign capital are dark clouds hanging over America's economic future. The key to bringing down the dollar in a healthy way and ending our dependence on foreign capital is to reduce the projected deficits in the federal budget. What matters is not just the deficit for next year but, even more important, the prospects for the deficit in 1987, 1988 and beyond. As the Congress moves forward to vote on a budget in the coming months, the opportunity to solve the critical problems that we are discussing this morning will be in your hands.

Chairman LAFALCE. Thank you very much, Dr. Feldstein.

Before we question you, we will first hear from Dr. Bergsten, and then we will question you together.

Dr. Bergsten.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Thank you very much. What I will try to do is three things: Elaborate a bit on the data and suggest how bad the situation really is; discuss the evolution of the United States into debtor country status; and talk about the implications of that movement; and suggest a few remedies.

I agree completely with Marty Feldstein's presentation this morning, and so I will in a sense be elaborating on his remarks, providing a bit more detail.

First, on the numbers, it is relevant to note how ominously similar are the developments in our own international accounts with those of those much-maligned debtor countries in the Third World.

Marty referred to that point, and I come back to it time and again in my statement, because as one thinks about the situation it is ominously similar. Our own current account deficit last year, for example, exceeding \$100 billion, was virtually identical to the current account deficit of all the debtor countries in the world taken together just before their crisis broke in 1982.

This year, when we add another \$130 billion or so to our external debt, we will become the largest debtor country in the world. By the end of this year, the external debt of the United States will exceed that of Brazil, Mexico, or any other country in the world.

In just this one year, we are accumulating more foreign debt than Brazil or Mexico has in its total history, so the pace is enormously rapid. If the dollar, whose overvaluation is the main villain, were to remain at anything like its current level, projections out through the end of the decade show that our current account deficit would continue to rise and would hit something like \$300 billion a year by the end of the decade, by which time our net foreign debt would be well in excess of \$1 trillion.

Even in terms of the usual ratios, that would take our ratio of foreign debt to exports well above the traditional crisis level at which other countries have faced stabilization crises, and indeed, major international disruptions.

The United States is going into external debt faster than any country in recorded history. Our current account deficit is approaching an astounding 50 percent of total exports of goods and services, compared with about 10 percent for socialist France at the height of its abortive "dash for growth" in 1981, and about 20 percent for the Third World debtors just before their crises erupted.

As a result of the huge and growing current account deficit of the past 3 years, the United States has already become a debtor country, and has frittered away its position as the world's largest creditor country, accumulated over 65 years, in just over 2 years.

By around 1989, unless the dollar returns soon to a level compatible with the underlying competitive position of the United States in world trade, U.S. external debt could exceed the total external

debt of all the developing countries, which we still call "the debt crisis," but is being increasingly rivaled by our own problem in terms of global difficulties.

I mention two statistical points that are worth taking into account, because you may sometimes hear people say the numbers don't accurately represent the real underlying position. It is true that the United States has a lot more direct investment abroad than foreign direct investment here, and the way the numbers are kept, that probably understates the level of our international assets.

On the other hand, there has been a tremendous underreporting of the degree to which capital flow has been coming into the United States.

Marty and I have already mentioned how big those numbers are in recorded terms, but there is something in the U.S. balance-of-payments accounts called the statistical discrepancy, errors and omissions. They have accounted for over \$200 billion since 1978, most of which is probably unrecorded capital inflow, which means that our external debt is probably much greater than the numbers recorded.

And our payments on them are probably much greater than is showing up in the balance-of-payments accounts and, therefore, if anything, I would suggest that the official data understate rather than overstate our international problem.

Chairman LaFALCE. By approximately how much?

Mr. BERGSTEN. Probably by \$100 billion or more.

Chairman LaFALCE. Over what time frame?

Mr. BERGSTEN. That would be the outstanding stock. The net is probably understated by \$100 billion or so, which means that we probably already became a debtor country a year ago in real terms, though the official data show it is happening only in the first quarter of this year.

In short, the situation is even worse than most people think, and even worse than the recorded data show. Second, what are the implications of all of this?

Marty has already talked about the macroeconomic implications, the fact that we are hooked on foreign capital inflow to maintain our private investment increases and finance the budget deficit, and I agree with him on that.

In addition, I would note the increased vulnerability of the United States in both economic and foreign policy terms, as we become a huge net debtor country.

One can't put a simplistic relationship on it, but to the extent that one is held increasingly hostage by requiring foreign capital inflow to keep his economy going, one becomes increasingly vulnerable to the withdrawal of funds already put in here by private investors and also official bodies abroad. There are going to be constraints affecting our foreign policy and our economy by the fact that other people have so much claim on us, and put us so much in their debt, as we form our own economic and international security policies.

A very practical effect is the big shift from our earning lots of money on our foreign investments to a situation where we are now

beginning to pay money on our international position, and that number will increase sharply.

As recently as 1982, we were earning over \$30 billion a year on our foreign investments. That meant that we could run a merchandise trade deficit, as we did in 1980 and 1981 of \$25 to \$30 billion, and offset the merchandise deficit by our earnings on accumulated foreign assets.

Now the situation reverses. As we become a debtor country, we have to be a net payer of interest to the rest of the world. That means we have to run a surplus on our merchandise account in order to balance the books, and I think that is what Marty referred to when he said that our children will be paying for this.

We will have to transfer real resources abroad to earn the money to pay on our foreign debt, just like Brazil or Mexico has to do today.

We are now decimating the very firms and industries that are going to have to improve their position to earn that export surplus, however, because those are the very ones that are being so savaged by the overvalued dollar. They are the hope for the future, who have to do so much better to put our books back into balance.

We will also, by having to run huge trade surpluses in the future, put a lot of pressure on the rest of the world's economy. Other countries are going to have to run deficits, and that is something not easily undertaken by other major countries around the world, which will cause further trade problems.

A related implication is that, clearly, the money that the United States is borrowing abroad is not being put into capacity to improve our trade position. When we support IMF or World Bank lending to Brazil, we want to make sure that the money is going into plant and equipment to earn foreign exchange to enable them to repay their debt.

But we are doing the opposite. We are seeing a further deterioration in our trade position while we are borrowing the money, the opposite of what we seek other countries to do. Our tradeable goods industries are thus getting worse and worse as we borrow the money, not better and better.

Our position is thus worse than that of those Third World debtors who themselves wind up much maligned. There are a number of implications, and the problem is extremely serious and adverse for the American economy.

Many people will, of course, say that America is different. America is not like Brazil or Mexico. We are a much stronger economy, and our investment level is up. What is all the hoopla? What is the difficulty?

Well, I have already pointed to how severe the numbers are, and I would echo also Dr. Feldstein's point that the situation is unsustainable. One could, I suppose, argue that the situation that we now see is a good one for the United States in that the rest of the world is financing a consumption boom here, and if the rest of the world were willing to go on financing that, I suppose one could argue that it was desirable for the United States.

I wouldn't argue that, because the decimation of our tradeable goods sector and the implication of being a large debtor are bad

enough—so I don't regard the situation as desirable. In addition, it is clearly not sustainable.

If we were to stay on this current path, with the U.S. current account deficit rising steadily, we would literally have to be attracting something like half of all the savings generated outside the United States each year to come into the dollar, to keep the situation afloat.

That is not going to happen. As Marty said, at some point, the foreign investors are going to go on strike and not put the new amounts into the dollar that are necessary. Indeed, they may start pulling investments out that have come in in the past, and we will get higher U.S. inflation and interest rates; we may very well have a new recession.

It is hard for me to suggest which manifestation of this imbalance is going to break first—this external manifestation or the internal manifestation, which asks how long our body politic will be willing to take trade deficits of \$100 billion and rising.

We all know how protectionist trade policies have been rising, and with the loss of our price competitiveness, it is no surprise that protectionist measures are accumulating in the Congress. I fear that it may be that internal manifestation of the big imbalance that breaks before the lack of foreign capital pushes the dollar down and, for all the difficulty it would cause, would at least begin to correct the external situation.

In short, we have a fundamental contradiction in current U.S. economic policy. On the one hand, the administration has sought, sometimes courageously, to maintain an open trading policy and is trying to get the world to agree to a new round of trade-liberalizing negotiations. On the other hand, the huge budget deficits and associated high interest rates have created such a strong dollar and enormous trade deficit that it is very difficult for the United States itself to maintain a liberal trading policy.

This is a fundamental contradiction between the trade policy effort and the international monetary consequences of current macroeconomic policy, which leads to the enormous pressure on trade policy that we have now.

Finally, what should be done about it? First, I would suggest that it would be a major mistake to try to deal with it through import controls, import surcharge or other trade devices. They are not only bad policy, because they would disrupt the world economy and the Third World debt crisis as well, but they probably wouldn't work.

If the United States put on import controls or any kind of comprehensive trade measures, it is likely that the dollar would strengthen more and would offset any trade balance again that might be achieved, through the import surcharge.

Indeed, U.S. exporters would be further disadvantaged by the situation with no offsetting gain, and we would not achieve any net gain, even for the trade balance, let alone taking into account the external consequences of the United States taking such action.

The things that should be done derive from what Marty started out with—the need to cut the budget deficit very substantially.

It has to be done by very sizable amounts. The target of cutting the deficit by something like \$150 billion annually by fiscal year

1988 is about right. I am afraid that the progress that we are now seeing in the Congress, however, and particularly in the conference committee, may not be adequate to achieve anything like that target.

And I further fear that tax reform may become a tax cut, and may make the budget situation worse. So all those issues have to be very closely watched by you here in the Congress as you address them.

Once the budget deficit was dealt with significantly, then the Federal Reserve would be able to ease monetary policy a bit further. Real interest rates, despite recent declines, are still very high and need to come down further to promote a dollar correction. Furthermore, the top officials of the administration need to indicate they want to see a correction of the dollar. You mentioned that the President has said publicly that he likes the strong dollar, despite the fact that it is decimating a very large segment of our economy and creating this debtor country problem. That has a big effect in the exchange markets, and we need to get clear statements from administration leaders, the Fed leadership, and Congress, that the United States wants to see a correction of the dollar to accurately reflect underlying competitive realities.

The dollar is now overvalued in trade terms by about 40 percent, so we are putting a tax of 40 percent on all goods we try to export and subsidizing all imports by about 40 percent in terms of price. If any company had seen its prices deteriorate by 40 percent in 4 years, it would be in chapter XI.

Yet, the United States, as a country, has suffered that loss and that is the problem. There are a variety of things that could be done, short of dealing with the budget deficit and interest rates, and may have to be if those actions are not taken—but those are second best, and I will hold off on them and let you have questions.

[The prepared statement of Mr. Bergsten follows:]

THE UNITED STATES AS A DEBTOR NATION

Statement of
C. Fred Bergsten
Director, Institute for International Economics

Before the
Subcommittee on Economic Stabilization
House Committee on Banking, Finance and Urban Affairs

June 20, 1985

The Second Debt Crisis

The international position of the United States is now developing in an ominously similar way, both qualitatively and quantitatively, to that of the developing countries during 1973-82:

-- Our current account deficit in 1984, at about \$100 billion, was virtually identical to the current account deficit of all the developing countries, taken together, in 1981--the year before the first debt crisis broke. Net capital inflows of a like figure were of course needed to finance that deficit, and increased our net foreign debt accordingly.

-- By the end of 1985, the United States will be the largest debtor country in the world--substantially exceeding Brazil and Mexico, the current "leaders" in this dubious competition. We will accumulate more net foreign debt in just this one year than their cumulative historical totals!

-- If the dollar were to remain at current levels, which overprice American products in world trade by about 40 percent, and even if US economic growth were slower than that of the rest of the OECD for the remainder of this decade, American current account deficits could rise steadily and exceed \$300 billion by 1990. On this scenario, the net external debt of the United States would exceed \$1 trillion by 1989 and rise by \$300 billion or so annually thereafter. This trend would take our debt/export ratio beyond 200 percent, the traditional trigger point for debt crises and much higher than that of any other industrial country,¹ from 1988 onward.²

-- The United States is, in fact, going into external debt faster than any country in recorded history. Our current account deficit is approaching an astounding 50 percent of total exports of goods and services, compared with about 10 percent for Socialist France at the height of its abortive "dash for growth" in 1981 and about 20 percent for the Third World debtors just before their crises erupted.

-- As a result of the huge and growing current account deficit of the past three years, the United States has already become a debtor country--and has frittered away its position as the world's largest creditor country, accumulated over 65 years,

1. See AMEX Bank Review, September 17, 1984, p. 3.

2. Stephen N. Marris, Deficits and the Dollar: The World Economy at Risk (Washington: Institute for International Economics, forthcoming 1985).

in just over two years. By around 1989, unless the dollar returns soon to a level compatible with the underlying competitive position of the United States in world trade, US external debt could exceed the total external debt of all the developing countries--which we still call "the debt crisis."

Even if a major dollar correction were to begin promptly, the trade figures would not show much improvement until 1987 and beyond; a very large part of this basic structural change in the world economy is now assured. If dollar correction did occur promptly, the next external debt of the United States would still rise to at least \$300-400 billion because of (1) the time lags involved in moving from currency correction to trade improvement and (2) the huge level of the deficit (probably \$125-130 billion in 1985) which has to be worked down.

Two statistical caveats are worth noting. On the one hand, US assets abroad consist much more heavily of direct investment (\$226 billion, end-1983) than do foreign assets here (\$133 billion). Since direct investment is calculated at book rather than market value, and since the stock of US direct investment abroad is considerably older on average than the stock of foreign direct investment here, our net creditor position on that account is probably understated.

On the other hand, the extent of foreign capital flow to the United States in recent years has almost certainly been significantly understated. During 1978-82, the US accounts included an unrecorded inflow ("statistical discrepancy" or

"errors and omissions") which cumulated to over \$130 billion. Some of this could be unrecorded exports of services, but "the discrepancy was probably in large part accounted for by unrecorded capital inflows."³ Hence, if anything, the official data today probably understate rather than overstate the US international debtor.⁴

The Implications of Debtor Status

There are numerous implications which stem from this return of the richest country in the world to its 19th-century status as a debtor nation, when we were a developing country.⁵ One is the huge misallocation of world resources which is suggested. Another is increased vulnerability for the dollar; my earlier studies show that the dollar crises of the 1960s and early 1970s

3. Survey of Current Business, August 1983, p. 43, in explaining the anomalous further rise in the US international creditor position in 1982 despite a current account deficit of \$11 billion. No such anomaly is conceivable now, however, because of the much larger magnitude of the current account deficit. See also Richard Dale, "Is the US Already A Net Debtor?" in The Banker, December 1984, pp. 8-9, who points out that the sizable understatement of capital inflows has produced a subsequent understatement of interest payment to foreigners; thus the US current account has appeared stronger (by \$10 billion or so by 1983-84) than has actually been the case.

4. A third caveat is that valuation adjustments, such as the recent rise in value of US stocks and bonds, also affect the international balance sheet of the United States in ways not related directly to the current account position.

5. The United States was still a net debtor, to the tune of \$3.7 billion, in 1914 but had moved to creditor status of a similar magnitude by 1919. See Hal B. Lary, The United States in the World Economy, Department of Commerce, 1943, pp. 122-24.

were all associated with a decline of key US "liquidity ratios"--the relationship between our reserve assets and foreign dollar holdings, on various definitions⁶--below 100 percent, and a shift to net debtor status could be expected to have substantial impact as well.

There are bound to be foreign policy, and even national security, implications as well. Is it conceivable that the world's greatest debtor can remain the world's greatest power? Britain's political and economic declines followed a similar path, the latter perhaps best proxied by her decline from being the biggest creditor industrial country (as a share of GNP) in history in 1913 to virtual elimination of that position by 1945.⁷

One very practical effect of the shift is that the US current account will no longer benefit from net earnings on foreign investment--because the foreign investment account will be in deficit rather than surplus. Our net investment income peaked at over \$33 billion in 1981, but that surplus will

6. C. Fred Bergsten, The Dilemmas of the Dollar: The Economics and Politics of US International Monetary Policy (New York: New York University Press, for the Council on Foreign Relations, 1975), esp. pp. 148-152.

7. Interestingly, the United Kingdom is now once more among the largest creditor countries in the world: at about \$75 billion at the end of 1984, roughly the same figure as for Japan and (estimated) for Saudi Arabia. By the end of this year, however, Japan will top the list at about \$100 billion--and, by the early 1990s, that figure is expected to rise to about \$500 billion and make Japan by far the biggest creditor. See Japan Economic Journal, June 4, 1985, p. 1.

probably disappear in 1986--even taking account of the higher return on US assets abroad because of direct investment's greater share in them.

The United States will thus have lost its cushion of investment earnings to finance a deficit in merchandise trade. Indeed, the situation will shortly reverse: a growing merchandise surplus will be needed to achieve anything like current account balance, because of the rising structural deficit in the services account. Herein lies a fundamental contradiction in the American position: the United States will have to run large trade surpluses in the future but the only industries which can provide such surpluses, by expanding their exports and competing more effectively with imports, are being damaged severely by the current overvaluation of the dollar and will thus be hard put to make their needed contribution.

Moreover, as a result of the change in its structural situation, the United States will be placing growing pressure on the world trading system. If dollar correction were deferred until the end of the decade, the United States would have to run merchandise surpluses of \$100 billion annually in order to finance interest payments on its net external debt and achieve current account balance. It is not clear which countries would be willing (or able) to run the corresponding merchandise deficits.

With its huge budget deficits, the United States is simply spending far more than it can produce at home and paying for the

excess by borrowing abroad. The borrowed money is clearly not going into export or import-competing production which will provide the foreign exchange earnings with which to repay the credits from abroad. In this sense, the United States is performing like some of the much-maligned Third World borrowers-- and is in fact performing much more poorly than some of them, like Brazil, which clearly did use their foreign credits to build export and import-substitution capacity.

As in the early stages of the LDC debt crisis, external finance is readily and enthusiastically available. The markets have excellent borrowers, this time in the US Treasury and American firms as last time with LDC governments and companies. Indeed, as indicated in the LDC situation by the rise in their reserves and in the present case by the extensive rise of the dollar, the supply of available funds is rising even faster than the demand for them. It is said that "America will always be a AAA borrower," just as it was said that "sovereign nations do not go bankrupt."

Perhaps a bit more curious is the analogous acquiescence or even quiet enthusiasm of the world's officials over the onset of this potential "second debt crisis." The other industrial countries are greatly enjoying the American stimulus to their trade balances. They are feeling little inflationary pressure, despite the weakness of their currencies, given the continued modest growth of their domestic demand and the weakness of world commodity prices. Hence the same complacency, and conspiracy of

silence, marks the dominant response to the buildup of American debt as to the earlier buildup of LDC debt. Even some of the reasons are hauntingly similar: export markets are growing, the financial sector is making a good return, foreign policy considerations counsel moderation or even cooperation, and the dangers--if any--seem remote.

How Serious Is It?

On the surface, therefore, the similarities between the LDC debt crisis of 1973-82 and the American debt crisis of 1981-? are striking. Indeed, as I shall mention later, there are striking similarities between this American situation and the previous American situation of 1966-71 which triggered the collapse of the Bretton Woods system of fixed exchange rates and the onset of global double-digit inflation.

But, surely, America in the 1980s is different. It is incomparably stronger than any of the LDCs, even the developing world taken together. Its investment level is up substantially, and at least some of the capital inflow is financing healthy new activity. It borrows in its own currency, which is the world's currency, rather than in foreign currencies as do virtually all other debtor countries. Its political system is once more stable, its economic growth relatively dynamic. Surely it will correct its remaining economic problems, notably the massive budget deficits and continuing high level of real interest rates. Hence the dollar may well stay up. If it does come down, say many observers, surely it will do so only modestly and in an orderly way.

Unfortunately, unless all economic history is to be turned on its head, the dollar will eventually have to come down quite substantially. As suggested by the past decade's experience under flexible exchange rates, it may come down very fast. When it does, US inflation and interest rates may rise sharply--perhaps triggering a new recession. Ultimately, then, the impact on the United States of going into heavy external debt may not be very different from the effect on Brazil or Mexico: a cutback in production and higher unemployment from recession (or at least slower growth), losses of real income via currency depreciation.

There are two sources of potential unsustainability in the situation, one external to the United States and one internal. The external constraint is the eventual saturation of dollar holdings in global investment portfolios and the resultant likelihood that, at some point, foreign investors will simply go on strike and be unwilling to buy enough dollars to finance the huge and growing American current account deficits without a rise in US interest rates and a decline in the dollar exchange rate.⁸ The internal constraint is the impact of dollar overvaluation on the structure of the American economy and the resultant pressure for protectionist trade policies--which could

8. It is sometimes forgotten that a fall in the dollar will be triggered whenever foreigners are unwilling *ex ante* to export sufficient amounts of additional capital to the United States, at current interest rates and exchange rates, to finance each year's huge and growing current account deficit. An actual "run" out of the dollar from previous investments, let alone a move into foreign currencies by Americans, would of course make the decline much sharper.

destroy the international trading system and reignite the LDC debt crisis.

The internal constraint may prove to have a shorter time fuse than the external constraint. In 1971, it was no Triffinesque collapse of the "dollar overhang" that brought on the dollar crisis of that day. Instead, Nixon and Connally decided that internal US interests required dollar devaluation and disruption of the contemporary monetary system--and were prepared to be as tough as necessary to get it. Similar events could well occur in 1985-86.

Throughout the postwar period, the exchange rate of the dollar--rather than the unemployment rate or any other macroeconomic variable--has been the most accurate "leading indicator" of changes in US trade policy.⁹ In the late 1960s and early 1970s, the substantial dollar overvaluation of the late Bretton Woods period engendered the most serious threat to an open US trading policy since Smoot-Hawley: the initial resort to steel quotas in 1968-69, the "Mills bill" passed by the House of Representatives in 1970, the Burke-Hartke pressures of 1971-72, the globalization of textile quotas at the same time. Only the devaluations of 1971-73, which corrected the American competitive position and trade balance, ended this threat to the world trading system.¹⁰ A similar episode, to a lesser extent,

9. See C. Fred Bergsten and John Williamson, "Exchange Rates and Trade Policy" in William R. Cline, ed., Trade Policy in the 1980s (Washington: Institute for International Economics, 1983).

10. And paved the way for Congressional authorization of the further liberalization of the Tokyo Round in 1974, despite an unemployment level higher than any which had then existed since the 1930s.

occurred with the more modest dollar overvaluation of 1975-76.

The current dollar overvaluation is producing even more worrisome effects. Despite the economic recovery of 1983-84 and an administration philosophically committed to free trade, American protectionism continues to rise. Indeed, the current administration has adopted more import controls than any of its predecessors since at least the 1920s. To be sure, the record could be much worse had the administration not successfully resisted some of those pressures. But its actions however are indicative of the enormous pressures generated by dollar misalignment and massive trade deficit.

The international economic policy of the administration has been plagued from the outset by a fundamental contradiction: its domestic policy mix and hands-off approach to the exchange rate have produced a dollar overvaluation which makes realization of its goal of freer trade almost impossible. This contradiction was never clearer than in President Reagan's State of the Union message in January, in which he called both for America to "become (sic) the investment capital of the world and for a major new round of international trade-liberalizing negotiations." Unfortunately, the economic and political effects of continuing, let alone more rapid, capital inflow to the United States would make it most unlikely that our domestic politics could avoid more protection--let alone support new reductions of our own trade

barriers and thus a successful international negotiation. Strong recent statements by Senators Bentsen and Danforth would seem to confirm this view.

Conceptually, the source of these pressures is easy to understand. The dollar overvaluation effectively taxes all American exports by 40 percent, and subsidizes all imports coming into the country by a like amount.¹¹ Few firms could survive such a loss of price competitiveness in four years, yet the United States as a country has suffered such an impact. American firms in the export and import-competing industries are being decimated. No sector is spared, from agriculture to high-tech. Indeed, it will take a decline of 25 percent in the dollar just to keep the US current account from deteriorating further, from the 1984 level of about \$100 billion, let alone improve back to anything approaching price equilibrium.¹²

One escape for American firms is to invest abroad rather than in the United States. Indeed, those already possessing foreign subsidiaries have been shifting their production offshore quite rapidly. When capacity utilization rises and new investments to meet global demand are needed, firms will simply

11. For the latest calculation of dollar overvaluation see John Williamson, The Exchange Rate System (Washington: Institute for International Economics, updated 1985), which will be released on June 25.

12. Stephen N. Marris, Deficits and the Dollar: The World Economy at Risk (Washington: Institute for International Economics, forthcoming 1985).

find it impossible to justify major expenditures at home in light of the cost disadvantage. Many are thus contemplating a renewed burst of foreign investment, as occurred during the previous period of sustained dollar overvaluation in the late 1960s.¹³

In addition, a number of American firms and industries, not just those traditionally vulnerable to foreign competition, are joining the chorus in advocating a protectionist approach to the seemingly insoluble problem of the dollar. Some sincerely, though misguided in my view, seek to resolve their real competitive problems under dollar overvaluation, in this manner. Others seek primarily to shake the apparent complacency, mainly of their own administration, over the current situation.

One current manifestation of this pressure is interest in an import surcharge. The notion of reducing the budget deficit by \$80 billion or so "at the expense of foreigners" (via a 20 percent surcharge with no exemptions on an expected \$400 billion of imports in 1986) is much more appealing than taking on irate farmers, veterans' pensions, social security or medicare recipients, or raising taxes.

In my view, an import surcharge would be an incredibly foolish step for the United States. The exchange rate of the

13. On the other hand, many firms hesitate to actually build new plants abroad in light of the weakness of other economies and the inevitable dollar correction which, even if delayed well into the late 1980s, could whipsaw their decisions to locate abroad in light of the time lags involved in bringing new production on-line.

dollar could be expected to appreciate further, in expectation of a surcharge-induced improvement in the trade balance, and (along with the inevitable foreign retaliation, see below) would vitiate any actual reduction in the trade deficit.¹⁴ American exporters would be pure losers, while import competitors would gain much less net than gross.

Moreover, any such step by the United States, the most successful economy in the world in recent years, would almost certainly trigger retaliation and/or emulation by most other countries--as already publicly announced by the European Communities. In addition, it could ignite default by LDC debtors who--unless they were exempted in the first place, gutting the measure of almost half its intended impact--would see the American surcharge (and foreign emulation of it) as ending any hope of their earning enough foreign exchange to service their external liabilities without unacceptable domestic costs. Imposition of major new trade barriers by the United States could thus severely disrupt both world trade and the international financial systems.

14. Some proponents of a surcharge argue that its ability to generate substantial budget revenues would bring interest rates and hence the dollar down instead. But the surcharge is inherently a temporary device whereas the markets are looking for lasting cuts in the budget deficit; there is little reason to believe that adoption of an import surcharge would produce a more substantial overall budget-cutting package, and some evidence to the contrary since such an "easy" source of revenue could readily deter serious efforts to reduce spending on a lasting basis. In addition, significant exemptions (Canada? the LDCs, or at least the large debtors? non-dutiable goods?) would be almost certain and would limit the impact of the step.

Remedies

What then should be done? The primary requirement remains for the United States to initiate a sizable, credible and sustained program to bring down its structural budget deficits by about \$150 billion annually by 1988--the target recently agreed by the Administration and Congressional leadership. Only by thus reducing the government's demands on the economy can America's internal and external accounts be moved toward fundamental equilibrium.

However, even a convincing attack on the budget deficit might not suffice to initiate the needed dollar correction. In the short run, it could even propel the dollar further upward and intensify the problem. Hence additional steps should be taken in conjunction with the central fiscal action:

- the Federal Reserve should take advantage of the budgetary tightening, with its anti-inflationary (and economic slowdown) implications and psychology, both to ease monetary policy further and to let it be known that they would be doing so.
- Administration, Congressional and Fed leaders should make clear publicly that dollar correction is one of the major objectives of the change in the policy mix and that they want to see an orderly movement toward lower exchange rates for the dollar. This would appear to require a substantial change in policy at least at the top of the administration, which seems to like the strong dollar because it facilitates

financing of the budget deficit and implies strong international confidence in current US policies.

- other major countries (notable Japan, Germany and the United Kingdom) should cut taxes to increase the profitability of investment there and hence the appeal of their currencies, and as an offset to the negative impact on their economic expansions of a declining dollar; they could do so without rekindling inflation or pushing up interest rates because of the concurrent appreciation of their currencies, and their success in eliminating previous budget excesses now provides them with substantial room to maneuver.
- once the dollar began moving in the right direction in the exchange markets, the United States and the other key countries should "lean with the wind" by together intervening substantially and consistently, as necessary, to assure that the corrective movement continued and achieved the desired magnitude.¹⁵

Failing adoption of a constructive package along these lines, the world may face a choice among decidedly inferior alternatives. To head off a major disruption (or at least continued erosion) of the world trading system via an extensive outbreak of new trade controls, like a US import surcharge, it may be necessary for Europe and Japan to adopt controls on their capital outflows--to limit the incessant flow into the dollar.

15. C. Fred Bergsten, "The Case for Leaning with the Wind," Financial Times, October 24, 1985, p. 19.

They could either adopt Interest Equilization Taxes, as the United States did when facing similar circumstances during 1963-1974, or--particularly in the case of Japan, but again following the American example of the 1960s--limit outflows via "moral suasion." The governments of these countries could launch sizable foreign borrowing programs of their own, in addition, to draw back some of the vast outflows they are now experiencing.¹⁶ There would of course be leakages in all these efforts and the measures would not have great impact for a sustained period, but they could prevent further deterioration of an already dangerous situation and perhaps galvanize more constructive and lasting responses.

It is virtually impossible to foresee the precise nature of the outbreak and evolution of a crisis arising from the current situation, its timing or even in broad terms the events which will trigger it. Our analyses can, however, certainly identify disequilibria as large as those discussed here. In turn, it is clear that correction is inevitable. We can then see from the experiences of the past, as well as our basic conceptual approaches, the magnitude of the costs which are likely to result from leaving the problem untended until it is too late.

In the US case, all this smacks of *déjà vu*. In the late 1960s and early 1970s, the United States proved unwilling to

16. In the Japanese case, such borrowings have been dubbed "Nakasone bonds" on the model of the "Carter bonds" which were part of the successful dollar stabilization program of 1978-80.

finance responsibly its rapid increase in governmental expenditures for the Vietnam War and the Great Society domestic programs. Inflation rose considerably, but much more was exported via an increasingly overvalued dollar. The results, peaking in 1971, were a major deterioration in America's external position and the aforementioned threats to an open US trade policy.

As always, the price had to be paid. It was not avoided, only postponed. The two dollar devaluations of 1971-73 were the overt manifestations of the bill coming due.

The price was heavy indeed, for the United States itself and for the world as a whole. Double-digit inflation was ignited almost everywhere. The first oil shock was encouraged, if not caused, by these events in the industrial world. The inflationary decade of the 1970s, and the deep recessions of the mid-1970s (for some countries) and early 1980s (for virtually all countries), trace their roots directly to these events. We are still paying much of that price.

By comparison with today, the disequilibrium of the early 1970s looks miniscule. The American internal and external imbalances are several times higher as a share of American GNP, not to mention in absolute terms. The pileup of American debt, whether compared with domestic or global scale factors, is enormously greater. The threat to the trading system today makes Burke-Hartke pale by comparison.

In a sense, the US imbalance of the late 1960s-early 1970s was the forerunner of the two major debt crises of the postwar period, those of the LDCs of 1973-82 and today's American rerun. Let us hope that, for once, policy wisdom--in both the United States and other countries--will perceive the risk in time and take effective action to preempt it. The fire brigade may not have enough water to douse this one once it ignites.

Chairman LAFALCE. Thank you for a very powerful statement.

In summarizing your comments, you said you would elaborate upon the data of Dr. Feldstein, and you discussed implication and cures. You didn't say you would discuss its causes, but in your presentation of cures, you put so much emphasis on the budget deficit.

I clearly think it is the budget deficit which is the primary cause of the overvalued dollar, the high interest rates, and, therefore, the U.S. trade deficit and debtor status, correct?

Mr. BERGSTEN. Yes, absolutely correct.

Chairman LAFALCE. Fine. Also, did I hear you say that the debtor status of the United States, as it exists today, and as it looks as if we are going to be in the future, is tantamount to the United States being in bankruptcy under chapter XI?

Mr. BERGSTEN. In a technical sense, countries do not go bankrupt.

Chairman LAFALCE. I said tantamount.

Mr. BERGSTEN. Quite similar. The point is made, as I mentioned, that the United States is not Brazil or Mexico. We borrow in our own currency and we can't have a bankruptcy, in the sense of running out of foreign exchange. But that is a technical distinction without a difference, because when a Brazil has to go through a debt crisis, as it has, it has to adjust its economy.

It has to cut its budget deficit and strengthen its trade balance. It has to reduce its rate of inflation. It has to devalue its currency. It has to do a series of things that mean a real loss of income for the country. It has to go through a period of much slower economic growth, and that is a real cost.

At the end of the day, the United States is going to have to do the same thing. Our currency is going to have to come down by a lot, and that will reduce our real income.

Chairman LAFALCE. Do you think there are any prospects for a glide landing or is it almost inevitable the way we are going to have an emergency landing?

Mr. BERGSTEN. The history of flexible exchange rates, which we have now lived with for about 12 years, suggests that a soft landing is pretty hard to come by.

The exchange markets operate frequently along bandwagon lines, and when movements get going, there tends to be a cumulative effect that pushes the rates very rapidly and overshoots back in the other direction.

Six or seven years ago, the dollar was weaker than called for, and we could see that again as this decline begins to take place.

Chairman LAFALCE. What are your thoughts about it?

Mr. FELDSTEIN. I wouldn't be surprised if we saw a decline in the dollar of about 20 percent in the next 6 months.

Chairman LAFALCE. Would you call that soft?

Mr. FELDSTEIN. That would certainly not be overshooting. I agree with Fred Bergsten's estimate. We probably have a dollar that is 40 percent too high, that has to come down by 40 percent to bring it back into a sustainable level, so a 20-percent decline wouldn't be overshooting, and since we have seen the dollar rise by almost that much in a year and a half, it wouldn't have adverse effects on the economy if at the same time, we are beginning to make significant progress in reducing projected Government borrowing.

The thing that worries me is this: If financial markets see the dollar coming down and a smaller inflow of capital in the future from the rest of the world and at the same time, don't see progress in bringing down our Government's borrowing, then there is a crunch in the capital markets that produces much higher interest rates.

Mr. BERGSTEN. That is the hard landing scenario. If the dollar comes off 20 percent in 6 months, that would be fairly sharp without the proper internal policies being taken.

Interest rates shoot up, inflation goes up, and we sow the seeds of a possibly sharp recession.

Mr. FELDSTEIN. A 20-percent decline in the dollar combined with good monetary policy can be a healthy thing.

Chairman LAFALCE. We have had previous testimony from some economists that say, first of all, we don't agree that the budget deficit and the high real IRS are the primary cause of the overvalued dollar, and the trade deficit or the overvalued dollar, that it is primarily the economic revitalization that we have witnessed here in the United States, and the fact that we have such political and economic stability, at least relatively speaking, looking at any place else in the world, and the reduction of the budget deficit might well have the effect of improving our economic prospects, our economic and political stability and, therefore, make the U.S. dollar even more attractive.

Would you care to comment on that?

Mr. FELDSTEIN. I think they are wrong.

Chairman LAFALCE. Where, if so, is the fallacy of their reasoning?

Mr. FELDSTEIN. If you compare the United States and Switzerland now and a half-dozen years ago, we have both been politically stable countries. Half a dozen years ago, the Swiss franc was very strong, and the dollar was very weak. Nothing has happened to change the political stability of our countries. But U.S. interest rates have gone up a lot in comparison to our own past level, and in comparison to the level of interest rates in Switzerland. You can tell the same story about Germany and Britain. And it is that which is causing investors to want to put their money here rather than there.

Chairman LAFALCE. Whenever I advance the arguments that both of you advance, because that is basically my position, individuals have said, yes, but where else are they going to put their money?

Mr. FELDSTEIN. Where did they put it before? They put it at home. It is the natural thing to do; if you are a German bank, to invest and to lend at home.

Chairman LAFALCE. Wouldn't that mean that we would have to conclude that if they are Germans, it would be better for them to invest in Germany than in the United States, and is somebody in Brazil going to say it is better for us to invest in Brazil than the United States? Is somebody in France going to say it is better for us to invest in France than the United States?

Mr. FELDSTEIN. They did for a long time. Until 1982, we were running a current account surplus, exporting capital to the rest of the world.

Mr. BERGSTEN. I had the pleasure or pain to be sitting in a responsible position in the U.S. Treasury back in 1978 and 1979.

Chairman LAFALCE. When we were working together, it was pleasure; when we weren't, it was pain.

Mr. BERGSTEN. At that time, the dollar was undergoing what pundits were calling a free fall. It seemed that people were finding other places to put their money, all too rapidly in our view then, and even in retrospect.

In fact, the big problem of that day was so-called diversification, rapid movement out of the dollar. The mark was rapidly becoming a key currency, and people were moving into the yen. There was no problem finding other assets to put money into.

Chairman LAFALCE. My last question, and we will go to the others, but you said the big key word then was diversification. Let me tie that into the one question that both of you raised—what you, Dr. Feldstein, called the risk of satiation.

What is the criteria for determining satiation? Are we approaching it? Are we not? How do you make a judgment that we are near or not near the point?

Mr. FELDSTEIN. Nobody knows.

Mr. BERGSTEN. We are approaching it, Mr. Chairman.

Mr. FELDSTEIN. We are clearly moving in that direction.

Chairman LAFALCE. This, of course, tells us what we buy and sell.

Mr. BERGSTEN. Under flexible exchange rates, though this is the biggest and latest of these disequilibrating swings, none of the big turning points have ever been predicted or predictable.

It turned out to be an unanticipated event, sometimes a political event, that caused the eventual cessation of one trend and a reversal in the other direction.

Certainly those in the public domain never accurately predicted turning points and, therefore, one has to be honest and say we can't give you any scientific basis for saying when the turn would come.

Mr. FELDSTEIN. The appropriate policy actions and the seriousness of the current situation does not hinge on what happens in the short run to the dollar. If the dollar comes down sharply without progress on the budget deficit, that is bad news. If it stays up, that is also bad news. The bad news just takes a different form. In one case, it hurts the domestic interest-sensitive industries and in the other case, it hurts our trading industries.

We are building up larger and larger overseas obligations that are going to have to be serviced in the future by sacrificing American-made goods to pay for today's purchases.

Although it is fascinating to speculate how it is going to unwind over the next year, and a lot of money will be made and lost by people speculating, the key policy conclusion is independent of the outlook for that process.

Mr. BERGSTEN. The longer the proper policy response is delayed, the more costly becomes the current imbalance and the eventual correction.

Chairman LAFALCE. And a more permanent damage done to our industry.

Mr. BERGSTEN. And this foreign debt situation builds more and more. That is a structural change which will levy a permanent financing cost on us, the same way the buildup of the overall debt does.

Chairman LAFALCE. Dr. Feldstein, do you agree when Dr. Bergsten said it would help immeasurably if the President and the leaders of this administration would make clear that they consider the overvalued dollar to be bad rather than good?

Mr. FELDSTEIN. I think they have done that more than Fred indicated. Certainly, Mr. Baldrige, who is responsible for trade policy, has been saying things for 2 years.

Chairman LAFALCE. At a press conference, the President said, in effect, the overvalued dollar is wonderful.

Mr. FELDSTEIN. When he planned his trip to Bonn, one of the things on the agenda was trying to talk other countries into raising the value of their currencies relative to the dollar. It is always hard to talk down your own currency.

Chairman LAFALCE. Wasn't discussion of the dollar just about the last item that the President ever wanted to have on the agenda, and the last thing he ever wanted to discuss with them, because they always took the offensive, saying the primary cause is not us, but you?

Mr. FELDSTEIN. This year, he was in a much stronger position, because he could say he had put forward a budget which focused on cutting the deficit, and action was likely to come out of the Congress.

Chairman LAFALCE. Don't you think he should have been willing to respond to the initiative of the French to have parallel talks about an international monetary conference to deal with the problem?

Mr. FELDSTEIN. Yes, Jim Baker said a month before in Paris that we are prepared to do that. I don't think that was a real issue of contention.

Chairman LAFALCE. It seems to me that the President of the United States made it an issue of contention, by refusing to have parallel talks on that.

Mr. FELDSTEIN. We said we would host.

Chairman LAFALCE. Dr. Bergsten?

Mr. BERGSTEN. I am a bit more skeptical than Marty about current attitudes. We are both speculating about what was said in governmental discussions, but if you look at the report the Treasury sent to Congress in mid-March on the monetary system, they basically said everything is fine.

The report that the group of 10 is expected to adopt this weekend in Tokyo, the 2-year study called for at the Williamsburg summit—all indications will suggest that the monetary system is fine. There will be no indication there of looking to any basic changes, either in the current exchange rate alignment or to try to improve the system, so we don't get into these huge imbalances.

So I would be skeptical about the recognition of the problem and the zeal to do anything about it.

Mr. FELDSTEIN. The current system is a good system. We don't want to change the international financial system that we now have, but the fiscal policy that the United States—

Chairman LAFALCE. You don't want to go to a gold standard?

Mr. FELDSTEIN. No, and I don't want fixed rates by another name, or gold standards by another name, but I think that within this system, we have been pursuing an inappropriate fiscal policy. We have been permitting large budget deficits for the last few years which have created all these problems.

That is the issue, not the system of floating exchange rates.

Mr. BERGSTEN. I don't think any change in the system is going to come fast enough or be powerful enough to substitute for the essential policy actions now.

But I do think the monetary system is inadequate. To me, a monetary system internationally is only effective if it helps push countries in the direction of adopting national economic policies that work out in time to be internationally consistent.

We have had, throughout the period of flexible exchange rates, overshoots and imbalances that have gone back and forth, and a key reason has been inadequate national policies, not just now but in the past as well. But the international system is doing nothing to promote the adoption of more sensible and internationally consistent policies. I don't want to go back to fixed exchange rates or the gold standard, but in between is a target zone system where you try to agree on wide ranges within which currency should remain, and at least avoid the egregiously misaligned rates of the 40 percent nature that exist now.

Mr. FELDSTEIN. Say we had that agreement in 1980, and then the dollar started going up. Would it be advice for the Fed that they should pursue a more inflationary monetary policy?

That couldn't be a good outcome of this. Would it be advice to the Congress that it ought to deal with the budget? Sure, it would be such advice. But would that make the Congress do something different, just because we had some international agreement that there should be a target zone?

Mr. BERGSTEN. Mr. Chairman, it would have supported Dr. Feldstein's efforts as Chairman of the Council of Economic Advisers.

Chairman LAFALCE. I am afraid I will have to interrupt. Our distinguished ranking minority member, Representative Shumway.

Mr. SHUMWAY. I appreciate this discussion. It is a fascinating topic. I think perhaps we can sit here for days and hours. It seems to me that in all of these pursuits or discussions, we seem to get into areas of hopelessness and despair, there doesn't seem to be many bright lights at the end of the tunnel.

With respect to you, Mr. Chairman, and your line of questioning; that is, in our zeal to determine whether the administration has pursued a policy of a weaker dollar abroad or how well they have pursued that effort, if indeed they have, that we might be masking the real source of the problem. That is, we have this incurable tendency to spend beyond our revenues, and we continuously have budgets that have deficits.

And I think this problem happens to be a responsibility that falls squarely in the lap of Congress. You have said, Dr. Feldstein, in your response to the chairman's questions about the satiation point, you have indicated that no one knows when it is going to occur, even though we might be getting close to it.

And the thing that concerns me, and I am not concerned about the speculator's point of view, but rather than where action on the part of the policymakers is concerned.

Somehow, Congress must see the threat in real terms and must thereby be motivated to act. So far, that is not the case. We are still playing with the budget like it is a political document that we use to score points back home and get reelected, and we have not taken the kind of strides that I think are necessary to tame our propensity for deficit spending.

And perhaps we won't do that as lawmakers until we really are convinced that we are right on the very edge and we are about to fall over. In this respect, I am anxious to know how to identify those signals, and when they might appear, simply because I would think that to be the last chance Congress will have to do something. Maybe we will have to take that chance.

Mr. FELDSTEIN. It is not that there is a plateau and an edge, and as you get closer to it, you might fall off, but there is a little pinnacle here, and we are right up there, and we are going to fall off one edge or the other.

One edge is called the dollar plummets, and we don't make progress on the budget deficits and interest rates go up and housing collapses. The other is the one we are seeing every day, in today's GNP release, while consumption and investment improve and Government spending went up a little bit in the last quarter, our net exports deteriorated once again.

We are in very serious trouble for our export and competing sectors. That is the cliff that we are now falling off, and the fact we might be prone from that to a different ditch would not change the urgency of dealing with the budget deficit.

Mr. SHUMWAY. It is a question whether we can stand on that pinnacle and remain there?

Mr. FELDSTEIN. We are sliding off. It is this hump-shaped road and we are sliding into this ditch. The road may tip and we may slide back the other way.

Mr. SHUMWAY. There is no pleasing answer then?

Mr. FELDSTEIN. No pleasing answer along the route that we are going, unless we make significant progress to bring down projected budget deficits, that will allow a reduction in domestic borrowing, which in itself would lower interest rates, lower the dollar as well. The fact that there will be less foreign capital won't hurt us because the Government won't be demanding so much.

That is the happy ending we are looking for.

Mr. SHUMWAY. Instead of making a steep, sudden descent, it is a gradual decline downward?

Mr. FELDSTEIN. That is the hope, instead of a lopsided expansion as we are currently experiencing.

Mr. SHUMWAY. I have a question in passing, and you have both said we need to reduce the deficit to solve this problem, and there is a universality of opinion there.

All Members of Congress are convinced of that, but the question is how. Do we do it by cutting spending on raising taxes, and if we did that, what effect would tax increases have upon this overall scenario of foreign investment in this country? Is that the right answer for us to pursue?

Mr. FELDSTEIN. Personally, I like the proposal that the Senate passed, not every detail, but the roughly \$150 billion deficit reduction for 1988. But even with that, we would find ourselves with deficits which were permanently too high. To bring it down further from that would require taxes.

I don't think Congress in the end is going to pass that large of a spending reduction. That is going to make it all the more necessary to have some additional tax revenue, as well as major spending cuts.

What is the impact of those tax increases? It depends on how they are done. Some of the things in the administration's tax bill are counterproductive. They hurt investment, could destabilize the economy in 1986 by suddenly taking away the investment tax credit next year. But it is possible to raise revenue without doing damage to the economy and indeed, in a way, that does more good through deficit reduction than it does harm through the direct effects on the higher tax rate.

Mr. SHUMWAY. OK.

You referred to the crisis level, Dr. Bergsten, when you spoke about the rate of indebtedness. Apparently, we are moving toward that point, a similar analogy to Dr. Feldstein's.

I still don't quite understand what it is that sustains us as a nation with a relatively robust economy without having the kind of runaway inflation that characterizes those Third World economies, Brazil, Mexico, for example.

We are still relatively stable, and yet, we apparently are quite close to that level, and as you pointed out, we are sustaining a level of indebtedness, almost more than all of the Third World nations combined, together with those factors that would tend to be very destabilizing to our economy.

And you mentioned also the fact that investment is up. I take that to be the case, though I suppose we are still not saving as much as Japan. What keeps us alive at this point?

Mr. BERGSTEN. On the inflation point, the most striking difference between us and most other countries, including those developing countries, is that we have had a responsible monetary policy. The Federal Reserve has not yielded to the temptation to monetize the big budget deficit. Indeed, it has been willing, despite the criticism, to see real interest rates shoot very high, and that has wrung out a lot of inflation.

A second point that is relevant to our topic is that we have exported some of our inflation. The strong dollar does have the significant benefit, at least in the short run, of holding price levels down within the United States. It makes imported goods cheaper per se, and keeps a lot of pressure on domestic firms competing against imports in our domestic markets. You could view the strong dollar as kind of an income policy or wage policy.

It keeps very severe pressure on wage levels and pricing policy in that large sector of manufacturing that has to compete internationally. That is the beneficial side. Part of the explanation for rapid U.S. economic growth in 1983 and early 1984, with continued relatively low inflation, was the strong dollar, which did permit that combination of events to result.

Again, however, one has to look at the other side of the pinnacle, when the dollar comes down. Even within the most constructive scenario that Dr. Feldstein has elaborated, with the budget deficit coming down too, there will be a temporary increase in the inflation rate because the dollar is coming down. It could push inflation up rather substantially for the temporary period of the correction, and then, when it is back to a new, hopefully stabilized level, you will drop back to the core or underlying inflation rate. But that has been a substantially positive element and one reason for the result that you mentioned.

Mr. SHUMWAY. One more question, if I may.

You mentioned also the protectionist measures, and you spoke against any kind of import controls. Would you categorize the swelling of protectionist bills that we now see in Congress as being, therefore, a superficial solution to this problem, or how would you describe it?

I would like to hear that in your own words.

Mr. BERGSTEN. It is not surprising. I have done some analysis of the history of U.S. trade policy in the postwar period, and the best leading indicator of protectionist pressures is the dollar.

In previous periods, when the dollar is overvalued, you have had substantial pressure in the same direction. Not just the industries traditionally vulnerable to imports, are then looking for help, but highly competitive firms and industries are also hit by a price differential as high as 40 percent and look for immediate relief.

I think, however, that import relief would be superficial and possibly even counterproductive. If we put on an across-the-board import charge, that would give promise of improving the trade balance, and an improved trade balance, everything else equal, should strengthen the dollar.

So even though you raise the price of imports by putting the tax on them, you would also be simultaneously reducing their price further by having the dollar rise further, and on balance, there might be no gain at all in the trade balance.

Mr. SHUMWAY. You talked about a 40-percent differential, if the tax were pegged at the same level—wouldn't one offset the other?

Mr. BERGSTEN. It would if the exchange rate didn't then change, but I suggest that it would change. We can't tell you with absolute certainty how much, but you would have to say the dollar would strengthen even further.

If you put on a 40-percent import tax and export subsidy, the dollar should then strengthen by that same 40 percent. You would have no net gain on your trade balance.

If it was just an import surcharge, you would gain some revenues. But that wouldn't help either and it would be a negative factor in the market, in terms of interest rates and the underlying attack on the dollar that we are both advocating.

Mr. FELDSTEIN. A comment on that last point. What Fred said about the exchange rates moving to offset anything you do by tariffs is only true if those are expected to be permanent tariffs.

A temporary tariff would not cause the exchange rate to move that much, if at all, and it would give you, therefore, the trade restriction effects associated with the tariff. Those are bad. They

create the wrong kind of incentives, and would hurt the economy and would not deal with the fundamental problem.

Chairman LAFALCE. Congressman Erdreich?

Mr. ERDREICH. Let me get a couple of ideas about interest rates. Were each of you surprised that we got the 9½-percent prime?

Mr. FELDSTEIN. People have been saying we were going to get that kind of reduction. Short rates have come down largely because of the perceived weakness of the economy.

In addition, the Fed has clearly been content to provide more expansionary monetary policy. Inflation expectations, which 1 year ago were still very, very high, have really been reduced.

Mr. ERDREICH. Do either of you expect interest rates to continue to go down further? A few more notches?

Mr. FELDSTEIN. It is easier to talk about the longer term rates, and I think they are more important. Longer term rates could come down a good deal further if Congress seems to be making progress on the budget deficit.

A certain amount of that fall, the 250 basis point fall in long rates that has occurred, reflects a growing confidence that some action is going to happen this year, especially after the Senate vote on the budget earlier.

If that seems to be falling apart, we could see that reversed and see those rates go up. Conversely, if that progress looks like it is going to get locked in or if Congress starts talking more seriously about tax revenue in a positive way, that could give us further progress on those long rates.

Mr. ERDREICH. Would you expect the continued fall, or if it stays where it is, to have a direct impact on capital inflow?

Mr. FELDSTEIN. Yes. The fact that the dollar has not come down more in the last 2 months is a puzzle. Both of us agree that the thing that connects the dollar and the rest of the economy is the interest rate and the fact that real long-term rates have, I think, quite clearly come down in the last 2 months, and that that has not been matched by any movement since late March in the dollar-German mark exchange rate as the dollar-Swiss franc rate is a puzzle.

Mr. ERDREICH. I am glad you guys are puzzled, too.

Mr. BERGSTEN. A major factor in the interest rate outlook will be the strength of the underlying economy. The second quarter was back up from the first quarter.

The joker in the deck is the exchange rate. If the dollar were to fall sharply because the satiation point is reached without the budget deficit being on its way to significant reduction, interest rates could rise sharply.

During the period of rapid expansion of the economy, 1983 and early 1984, real interest rates here were held down several percentage points by the capital inflow associated with the budget deficit and strong dollar. That could reverse if the dollar falls without the constructive and relatively stable policy approach we are both advocating—but we don't yet see put in place.

Mr. ERDREICH. Improved trade, ability to export if we can get to that point at some period in time. What sort of steps do you see would be helpful toward improved trade beyond the dollar valuation?

Is that the item?

Mr. FELDSTEIN. It is so important in comparison to almost anything else we can do. We can do things to improve our competitiveness in particular markets. If the Europeans didn't follow their current agricultural policy, American agriculture could stand a better chance in world markets. If some of the other markets, if the unfair practices pursued by some of the European governments were not being pursued, those industries would be better served in world markets. But it wouldn't change the overall balance.

We would gain in some markets and lose in others, because the thing that is driving the net trade deficit is the capital flows, and those capital flows are coming in response to the overall attractiveness of investment opportunities here.

We could do a variety of things other than reduce the deficit to make those investment opportunities worse, but we wouldn't want to do those. If we discourage investing here, one of the byproducts of that would be a weaker dollar, and an improved trade balance, but that would be counterproductive for long-term growth.

The key thing is to get the national savings rate up. Favorable changes in IRA rules can help a little bit in that direction. It would also be good to avoid doing certain things in the tax legislation which could harm savings. But the key thing is getting the deficit down.

Mr. BERGSTEN. I would underline what Marty said, including the case of Japan. Japan is a major focal point of trade policy. There clearly are things we want to see the Japanese do in terms of opening their markets further, but the bulk of the problem is the dollar and macroeconomic policy.

I have looked at this historically, and we are in the third episode of major United States-Japan friction. When the dollar becomes too strong and the yen undervalued, that sharply increases the Japanese surplus globally and bilaterally with us. I am not in any way suggesting reducing the pressure on Japan to open its markets, but we have lots of closed markets to Japanese exports, too, in a wide variety of products, and if you got rid of all those restraints, I am not sure which way the trade balance would go.

Japan also has an economic structure which adds to the problem. Their very high savings rate greatly exceeds the domestic investment opportunities in Japan, and so those savings go abroad in the form of capital outflow. Japan is exporting \$5 billion of capital every month, the bulk of it coming into the dollar, and that is the proximate cause keeping the yen relatively weak against the dollar.

The yen is very strong against all the European currencies, is in fact at record highs against them, and the trade weighted average of the yen exchange rate has risen over the last 3 or 4 years. But it is still undervalued against the dollar, in large part because of their savings-investment imbalance, which is the opposite of ours. The two reinforce each other and create this huge disequilibrium. That is the underlying United States-Japan economic problem, and until that is resolved, we will have continued conflict on an ongoing basis.

Mr. ERDREICH. Thank you, Mr. Chairman. Excellent.

Chairman LAFALCE. I have to follow up on that, Fred.

How do you account for the fact that the increase in the value of the dollar vis-a-vis the yen has been less than the increase against any other major currency? If you look from June of 1980 to June of 1985, you see only a 14-percent increase or so, with respect to the yen, whereas if you look to the group of 10, it might be almost 80 percent.

Mr. BERGSTEN. Japan has done much better with its economy than the Europeans. You can characterize the world currency situation in three tiers. The dollar strong against all, Europe went against all and Japan in the middle.

Chairman LAFALCE. It points out that our trade problems with Japan are not simply macroeconomic and connected to the dollar, but that they might well be microeconomic, too.

Mr. BERGSTEN. If you look at the underlying structure of Japan's trade, remember that they run a massive deficit on food, petroleum, raw materials, and the like.

They have to offset that, even if they were in overall equilibrium, with a very large surplus in manufactured goods, which means selling to the other industrial countries. Structurally, I suspect, they would thus run a \$10 to \$15 billion surplus in their bilateral relationship with us even if both countries were in global balance.

Most of the increase in that level over the last 4 or 5 years can be attributed to the exchange rate, although you are right that, in absolute terms, it hasn't moved very much.

Chairman LAFALCE. Representative Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

First, a quick note on something Dr. Feldstein mentioned, talking about IRA's. It came to my attention recently that there is at least some study that indicates that IRA's have not improved the savings rate in this country, and you mentioned perhaps changing some of those rules somewhat.

Do you have some hope that IRA's could one day be a real factor in increasing the overall savings rate in this country?

Mr. FELDSTEIN. I think so, and at this point, it is hard to know what impact the expansion of IRA's actually had. First, we are just beginning to get data for 1982, the first year of the major expansion, and, second, the short-run effect of changing the IRA's, and the long-run effect, I think, could have been expected to be very different.

In the short run, individuals move money from one account to another to take advantage of the IRA rules, and don't have to do any additional savings to get the full tax break.

But what we know is that most American families do not have nearly enough assets to keep that up for more than a few years. There is very widespread acceptance of IRA's, so if those people who have started those programs keep them up for a few years, it will push up the savings.

Mr. COOPER. The general deficit question—it is implicit in your testimony that you accepted David Stockman's revised estimates of the deficit in the outyears, but on the other hand, both of you seem to endorse the action that the Senate had taken, the standard deficit, if you can believe it really has \$50 billion of deficit reduction in it.

But if you accept Stockman's revised deficit figures, you would have to be calling on Congress then to up its contribution to deficit reduction to \$60, \$70, \$80 billion this year and perhaps more, considerably more in the outyears.

Is that a fair assumption to make?

Mr. FELDSTEIN. I would be very happy to get \$50 billion in real dollars in 1986, and if you told me I could have \$100 billion, I would say no, thank you, because the importance is getting the deficits down in a major way in 1987, 1988 and beyond. But if you do too much upfront, you will surely push the economy into a recession in 1986; \$50 billion is a large enough amount to be a serious improvement in the deficit, and provide a great deal of credibility in the financial markets, and yet not to risk pushing the economy over the brink.

Much more than that would worry me, but the critical thing is what happens out in 1988, and I think that the goal of the 2 percent of GNP deficit there is one the Congress should keep in mind, and if that is not going to come out on the spending side, then it is important to look at the revenue side.

Mr. BERGSTEN. It is important to keep in mind, to the extent that David Stockman's, or CBO's reestimates are due to changes in assumptions about economic growth, that they are then reflections of what most economists call the cyclical component of the budget deficit as opposed to the structural component.

You must get that structural deficit down over the longer run and not be as worried about the absolute number of the deficit. If it were higher due to cyclical factors, that would mean less demand on the credit markets from the private sector and wouldn't have the adverse effects on the interest rates.

Mr. COOPER. That is reassuring. I am pessimistic we will ever get the \$50 billion this year. It seems to me that has almost been a euphoric move that gripped Congress in the last few months—interest rates coming down and people congratulating each other, having gotten a budget resolution out at all—

Mr. FELDSTEIN. The week of the biggest move in interest rates came after the Senate passed that budget, and it was that that triggered the stock market moves.

If they don't deliver on what they have indicated to the financial markets that they were going to deliver, that could easily reverse itself.

Mr. COOPER. There is a letter circulating that would put Members on record saying it would only vote for a budget compromise that would have \$56 billion of deficit reduction in it, and I suppose that is nominal instead of real, but even that has been difficult to get signatures on. I hope when the compromise is out, that it will produce those savings.

We have a real sales problem making this point clear to the White House and to the public at large. Could you help me answer a couple of sales questions?

Who would you gentlemen view as your adversary—if you were on "Nightline," who would you last like to debate?

Mr. FELDSTEIN. Your question is: Who I would least like to appear with on "Ted Koppel's Nightline." What class of people are at risk of being on the opposite side?

Mr. COOPER. It seems that we have so many people who want to believe good news about our economy, and so anxious to blame the Fed for many of our problems, that we have great difficulty in focusing our own attention and the attention of the public on the deficit problem.

We have difficulty persuading our constituents and others to make this problem an urgent problem before it is too late, and I am looking for some help in trying to spread that message. It seems to me that any help we could get would be more than what we have right now, if you have any ideas on that general subject.

Mr. FELDSTEIN. I have been trying for a long time to get people to be interested in the budget deficit. I am not sure I have any new ideas, but it is also true that the President, in his speech on the budget, made it very clear that he regards bringing the budget deficit down as a critical goal.

I believe he is a fiscal conservative. I believe he does not want to leave office at the end of two terms with a larger deficit than he came in with. I think he is trying to force Congress to do as much on the spending side as he can.

Mr. BERGSTEN. I would deviate in one sense. This is a uniquely Presidential problem. The problem of the dollar and the U.S. international position is hard to recognize and realize, because it is a creeping erosion, not a crisis that leaps up and forces you to take action. That is where political leadership at the highest level is required.

That is why I suggested in my statement that the President himself, as well as other top people in the administration, ought to be calling for a correction of the dollar.

I am sensitive to the risk of talking down your own currency—there were some charges that previous administrations did that. You don't want to do that, but you do want to call for a correction of the situation, a restoration of the international competitive position of the United States, a rise in foreign currencies. There are all sorts of ways to call for it.

Mr. FELDSTEIN. They talked about raising the value of other currencies rather than lowering the value of the dollar.

Mr. BERGSTEN. But they backed away from it at Bonn. They talked initially about the others taking action, but they backed away. Nothing happened and nothing is happening in the monetary system talks—which are different, but related.

I wish the President were out stumping for the budget package the way he has been stumping for the tax reform package. You can't focus on just one issue, but I worry that the new one is a bit of a diversion from the former. I wish that same pressure were being put on and these international dimensions were talked about every day at the top levels of the Government, to try to bring home why this one needs to be dealt with aggressively and effectively.

Chairman LAFALCE. It is easy to talk about the politics of joy rather than the politics of pain.

Representative Wortley?

Mr. WORTLEY. Thank you, Mr. Chairman.

We are all pretty much agreed on the importance of the budget, getting it under control for the long-term picture. Now it seems

that we have to take a hard look at our foreign trade policies as they exist and the tremendous flow of capital out of the country. Isn't it time to make some course corrections in our trade policy?

Mr. BERGSTEN. I would go back to what we suggested before. By far the No. 1 trade problem facing the country is this strong dollar. It prices much of American industry out of world markets and puts a 40-percent tax on our exports, and subsidizes imports by a huge amount.

That is the overriding problem. There are certainly other things to be done. I would criticize some of the recent moves to gut the Export-Import Bank, for example. I would criticize export disincentives, various embargoes have been put in place which raise the spectre of the United States being an unreliable supplier.

We need the major new trade negotiation that Bill Brock has been pushing for several years now, in order to get new rules of the road, to try to get liberalization and opening of markets for industries in which the United States is quite competitive, services and agriculture, and we will have to pay something for that.

Mr. WORTLEY. You would like to see a reconvening of the GATT?

Mr. BERGSTEN. We had the Kennedy round in the sixties, the Tokyo round in the seventies, and we need a round of that type in the late eighties, to bring whole new areas of trade into the GATT regime.

The GATT regime itself needs to be beefed up. My institute is about to publish a study about what could be in that, and how it would help the United States and world trade as a whole. There is a lot to be done in the trade policy area, but I think a lot of the legitimate concern that has been expressed in the last few years about our trade competitiveness, and identified as due to unfair practices abroad, is a misspecification of the problem. A lot of it goes back to the fundamental pricing, exchange rate and underlying economic conditions.

Mr. WORTLEY. We do have some serious problems, dumping in this country by other countries. Look at the steel industry, textiles, those are things that are creating our large deficit.

Do you disagree?

Mr. FELDSTEIN. I agree with everything that Fred says basically, and that has also been the administration's position on trade, including the desirability of a new GATT round, emphasis on services and agriculture, and so forth.

There is dumping in steel, and we have a quota system. I don't like quota systems, and I don't like dumping. There is no dumping in automobiles. There is no dumping in textiles.

The real problem is that textiles and apparel benefit U.S. consumers. Apparel can be made much, much more cheaply in Southeast Asia than it can be in Europe or the United States.

Mr. WORTLEY. It costs a lot of jobs, though?

Mr. FELDSTEIN. It costs jobs in the short run, and improves consumers' welfare and American overall welfare in the long term. Over time, we have been making that transition, and it is a pity when we go in the opposite direction, especially at the same time that we are talking about the need for these countries in Southeast Asia to improve their own standards of living and to believe in markets rather than in Government planning.

Mr. BERGSTEN. I would add that there is a reconciliation to the dilemma Marty posed. He doesn't like dumping or quotas, and neither do I. But we have antidumping laws. They have been tightened a lot, the time periods have been shortened, and the implementation has been much more effective in the last few years. They can be tightened further, and there have been efforts here in the Congress to do that. That is the right principle.

It was a mistake to go to a quota regime in steel just because there were a lot of antidumping cases. That was the intent of some of the parties to the transaction, but U.S. law and internationally-agreed norms are very clear.

When there is dumping, you hit it. I am very hawkish, in fact, in responding tit for tat to dumping and foreign governmental subsidies.

Trade has to be fair in that sense, and you have to avoid those distortions. But I think we have very clear remedies in our law, as sanctioned by international practice, to hit back with countervailing duties and antidumping duties. You do it wherever you can demonstrate there is a problem and try to deter those practices.

Mr. WORTLEY. Could I ask one more question?

Chairman LaFALCE. Sure.

Mr. WORTLEY. Any thoughts you might have on what the United States might be able to do to create greater economic growth? We need to have markets out there to sell our services and our products to. Part of our success so far is the overvalued dollar, but that won't last forever.

Mr. BERGSTEN. I think the administration made a right move in that direction prior to the Bonn summit, when it began pointing out that as the U.S. economy slows down, as inevitably it would after such rapid growth in 1983 and 1984, that the other major industrial countries had to begin to pick up the slack. Japan, Germany, and other countries are maintaining extremely conservative economic policies.

The core rate of inflation in Germany and Japan is essentially zero. They are all running external surpluses, and they should all be taking cautiously expansionary policy action, because they will need it to offset the decline in their exports to us, and to keep the world economy moving at a reasonable pace.

If the world economy drops back into very low economic growth, protectionist pressures increase further, the LDC debt crisis comes back, and the like.

The LDC's are worth a quick point. There has to be enough continued outside help for those Third World debtor countries, in terms of capital transfers, to keep them from screwing their economies down so far that their internal structures can't take it, but also to keep world trade going at a reasonable pace. Therefore, we need to be supporting the World Bank more than is now being done, and support continued infusions from the IMF in return for proper stabilization policy. That is an area, too, where our own growth interests call for a somewhat different policy than is now being carried out.

Mr. WORTLEY. Thank you.

Chairman LaFALCE. I am going to have a second round. In the 2½ years that I have been holding hearings, I don't think we have

discussed anything more important than this subject, and I don't think we have had finer witnesses than you two gentlemen today. It has been tremendous.

Fred, of all the points you raised, with all the facts you presented, the one that hit me hardest was, if we continue on the present trends of the past 2 to 3 years, the net external debt of the United States will exceed \$1 trillion by 1989.

That will make our position at least as bad or worse than the position of the Third World debtor nations, circa the end of 1982, beginning of 1983.

What would the consequences of that be for the United States and for the world, as we don't have a United States to bail us out there, as we were able to bail out those other countries.

If we do have this \$1 trillion net external debt by 1989, what will happen?

Mr. BERGSTEN. The trillion is a projection, not a forecast. As I said, things would be bound to happen between now and then to prevent its occurring.

Chairman LAFALCE. We will have a terrible recession between now and then.

Mr. BERGSTEN. A sharp fall may occur in the dollar for satiation reasons. But it is an honest projection, based on an internally consistent and realistic model of the dollar and the world economy. It assumes that the dollar stays at something like current levels—the level of the fourth quarter of last year, to be more precise. It also makes, in this context, a favorable assumption that U.S. economic growth would be substantially slower than economic growth in the rest of the industrial countries, which means imports here rise less than import markets abroad.

You then get these enormous consequences for three reasons. One is that the strong dollar, as it continued to rise through 1984, has not yet produced all the trade deterioration that will occur. There is a 2- or 3-year lag still to come. Second is the scale factor: our imports are 50 percent higher than our exports, and even if they grow at the same pace, the deficit will grow very substantially.

And third is this cumulating payment of foreign interest. These three factors are going to continue to drive the trade and current account deficits higher in the absence of an exchange rate correction.

Some forecasters say the trade deficit will turn down in 1986. No way. It is going to continue to get worse, and the debt will build to \$1 trillion by the end of 1989, and \$1.3 trillion by the end of 1990, if it keeps going up.

Chairman LAFALCE. Suppose we don't have that horrible scenario, but an earlier scenario, again not too good. Under this scenario, the foreign investors go on strike, and we are both anticipating that will happen once they reach the satiation level, and neither of you can come up with any criteria, and you say no one can come up with a criteria when we are going to reach that, it could be tomorrow.

What happens to two things? Number one, our standard of living, if the foreign investors go on strike, because the standard of

living of the Third World countries that reach this debt crisis fell off precipitously in a relatively short period of time.

And I am interested, since you said these foreign investments accounted for over 40 percent of capital formation in the United States, what happens to this capital formation, if they go on strike?

Mr. FELDSTEIN. Well, if they went on complete strike, if we had no capital inflow, we would have about half the level of net investment that we have today, assuming that Government budgets have not been corrected.

As far as the standard of living goes, we would not have to go through the kind of contraction that Mexico, Brazil did if foreign investors, so to speak, went on strike.

If the dollar came down sharply, that would give us the correction in the trade balance that would be needed. What happened in Latin America, when credit was unavailable to them, the only way they could move toward living with their international budget, to doing without that foreign capital, was to force a cut in imports by having a recession at home.

We wouldn't have to do that. We wouldn't have to do that, because the change in the exchange rate would do that for us. They didn't start with a 40-percent overvalued currency the way we are.

Mr. BERGSTEN. One embellishment on that: There is an accounting identity that says your net capital inflow has to equal your current account deficit, so once the situation began to reverse and the foreigners went on strike and were not willing to put money into the United States at the level necessary to finance these external deficits at current interest and exchange rates, then those two prices would change.

Our interest rates could go up and our exchange rate would start to come down. As we look back at the previous year, or quarter, or whatever, there would still be net capital inflow adequate to finance the current account deficit, but the prices necessary to attract that capital inflow could be very different. We would have much higher interest rates and much lower exchange rates. The exchange rates would be propelling a reduction of the trade deficit, and that would improve the economy from the trade balance side because it is the change in the trade balance that counts for GNP. But the higher interest rates would sharply crowd out private investment, depending on how much the Government budget requirement had been reduced, so it would be a combination of those different elements.

It could be very sharp and very severe the longer the correction is delayed. But I agree with Marty that it would not be nearly as severe as in Latin America. For example, their per capita income is not going to get back to the 1980 level until some time after 1990. This is a "lost decade" for Latin America. They had to put on the brakes and push into deep recession to reduce their expenditures of all types.

We would be switching our expenditures from one type to another. That would be painful and costly, but not nearly as costly.

Chairman LAFALCE. We clearly need more stable exchange rates which would be, I think, a considerable help, if not the most important thing that we could do. But in order to get more stable ex-

change rates, it seems to me that you need greater stabilization of your capital flows.

Now, how do we go about achieving greater stabilization of capital flows and, in particular, as a subset of that question, what could our financial institutions do to help achieve greater stabilization?

Mr. FELDSTEIN. Avoid large budget deficits, that is the answer. If we are going to have large budget deficits again of the sort that we have had, we don't want to avoid the capital flows and the exchange rate movements, because the fact that we were able to draw in \$100 billion of capital kept investment in plant and equipment and housing alive in the United States. It made the best of a bad situation. It was a safety valve for our domestic economy. If we could somehow have prevented that, blocked the inflow of capital, then the American interest-sensitive sectors would have collapsed in the last few years.

So what has happened has been a positive reaction to a bad situation, an ameliorating, modifying reaction. Looking ahead, though, what we want to prevent are the kinds of conditions in which it is a good thing to have a change in exchange rates and a change in capital flows, and we want to prevent these kinds of sharp fluctuations in budget deficits.

The other thing that causes a change in exchange rates is fluctuations in expected inflation, so shifts of monetary policy back toward an inflationary mode would be counterproductive for domestic reasons, and they would also cause shifts of exchange rates.

Mr. BERGSTEN. I differ from Marty on this. What he said was that the external disequilibrium made possible an 18-month boom, and he is certainly right on that.

Chairman LAFALCE. It sounds to me as if he said deficit financing is made possible, that is the reason it boomed.

Mr. BERGSTEN. Foreign capital made available deficit financing.

Mr. FELDSTEIN. He didn't intend to say that, Mr. Chairman.

Mr. BERGSTEN. But that is not an inexact characterization. As we look back from 1990 or 1995, it is not clear to me that we will say that it was making the best of a bad situation because the imbalances that were built up, that we are talking about today, could cause such adverse consequences subsequently to make that 18-month boom——

Chairman LAFALCE. That we would be better off in the future, had we not had this?

Mr. BERGSTEN. We would have been better off to have been forced to put the books in order without the short-run boom. I can't prove that. Marty may turn out to be right, if we get a soft landing for the dollar and all this works out with budget cutting of the type we are both advocating and it is fairly smooth. Looking back from 1995, we may then endorse what Marty said.

It is too soon to know the answer to that. My broader point would be that the better world would have been one in which, right off the bat, all countries were working together on how their own fiscal and monetary policy mixes would interact to avoid the build-up of problems of that type. That is what we ought to promote and why we need a better international monetary system.

Chairman LAFALCE. That assumes you don't have ideologues in any country.

Mr. FELDSTEIN. The historians are never going to be able to say whether if we had had a different kind of pain in the American economy in the last few years, with stronger exports, stronger performance in industries that compete with imports from abroad, weaker housing, weaker equipment and plant investment, whether that would have caused Congress to do something different to speed up progress in dealing with the budget deficit.

If it wouldn't have, then I think there cannot be much question that having this safety valve, spreading the pain between the domestic interest-sensitive and the external sectors was a good thing, but if more traditional crowding out of high interest rates and a collapse in housing would have forced congressional action sooner on the budget deficit, then it would be better to have more domestic suffering in order to cure the disease more quickly.

Chairman LAFALCE. Pretty close to what Fred said.

Mr. Cooper.

Mr. COOPER. I understand deficit reduction is by far the best way to approach the problem, but I am groping to discover whether it is the only way, assuming the worst, and Congress is unable to get its act together.

Is there any conceivable scenario which the Federal Reserve can solve some of our problems for us?

Mr. FELDSTEIN. I think the short answer is no. The Fed could take actions which would solve some of these problems temporarily, but create other problems. If the Fed pursued a more inflationary policy and the world came to perceive that, and it wouldn't take them long, the dollar would collapse and that would move us from one ditch to the other ditch, and it would also leave us with a residue of higher inflation that we have paid such a high price to eliminate in these last few years.

So I think that there is really nothing that the Fed can do other than to play an accommodating role in response to congressional action in the fiscal area.

Mr. BERGSTEN. There is one other class of measures which could be pursued if one concluded that the overriding priority was to bring the dollar down. That would be to try to manipulate directly the capital flows, and there are a variety of ways to do that; some are mentioned in my paper. It turns out those steps are better taken by other countries that are seeing their capital flow out to the United States, particularly the Japanese with that \$5 billion a month.

There are steps that could be taken which would significantly alter the level of that capital flow, at least for temporary periods, and would change the exchange rates.

That, however, has to be taken in the context of no change in the underlying budget deficits and the like, and so it would cause a lot of these very adverse consequences we mentioned on interest rates and the like.

If you were to conclude that the dollar problem and the trade deficit was so overwhelming that you had to do something about it, there are some other things, but they are in the category of second or third best.

Chairman LAFALCE. Could we use our international financial institutions to help stabilize those capital flows?

Mr. FELDSTEIN. Given that we have got this underlying problem, I believe it is a safety valve that gives us a healthier economy rather than somehow bottling up all the pressures in the domestic capital market.

Mr. BERGSTEN. Even if one does not agree with that, I don't think the international financial institutions, in the way you are thinking of them, could do very much. You want money going into the yen, the deutsche mark, into the pound sterling, and the World Bank does not lend to those countries. It would be strange for the IMF to start putting money into surplus countries, so I am afraid that the institutions, in terms of their lending programs, couldn't help.

The IMF is now being derelict in its most fundamental duty, which is trying to get a better mix of economic policies among the major countries. That is what they are supposed to be talking about in Tokyo.

Chairman LAFALCE. You don't think that is the primary duty?

Mr. BERGSTEN. It would be not only putting pressure on the United States to get the budget deficit under control, but to get the Germans, Japanese, and British to pick up some of the locomotion.

Chairman LAFALCE. More restrained fiscal policy on our part, a little looser on everybody else's part, right?

Mr. BERGSTEN. There was some talk about that in Bonn, but it disappeared. The IMF, in its international surveillance process, should be doing just that. The main outcome of the Tokyo meeting will be to beef up the international surveillance of the IMF. It must try to correct this huge misalignment of currencies.

Mr. COOPER. It is like a wet noodle, the IMF—

Mr. BERGSTEN. That is why I said earlier, more has to be done in terms of changing the system and putting in some norms.

Mr. COOPER. Is it fair to say that what we are talking about today should be the No. 1 economic issue in the 1988 Presidential campaign?

Mr. FELDSTEIN. I sure hope it is passed before that.

Mr. BERGSTEN. If it is not, it probably will become a major issue in that campaign.

Mr. COOPER. Next question is, I am afraid from a political standpoint, one of the main advantages of the international aspect of our domestic deficit crisis is, it makes it easier to sell to constituents, sometimes it is a way of beating up on foreigners, and stressing isolationist tendencies we have in this country.

It is an effective sales pitch that we are able to add to this aspect of the problem, and not able to add to others, and do you think that we risk by emphasizing this aspect of the problem too much increasing the isolation trends beyond the bounds which we should be increasing it?

Mr. BERGSTEN. One might have made that effort a couple of years ago when the problem was not as acute as it is now. Now, it would be impossible to ignore it because it has become so important in terms of impact on the overall economy.

If you try to ignore it and not talk about it, you would risk the issue is getting so much more out of whack that the tendencies

would be fostered even more. So the better course now is to talk about it, and try to get the action to correct it.

Mr. FELDSTEIN. The key thing is to emphasize the source of that problem is not the particular restrictive practice here and there abroad, but rather, that until we get our budget deficit down, we are going to have this kind of serious international imbalance.

Mr. COOPER. Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you.

One question on an unrelated subject, Dr. Feldstein. You are very concerned about the so-called tax reform for many reasons.

Mr. FELDSTEIN. I like it in many ways, and I have problems with some aspects of it.

Chairman LAFALCE. One of the principal problems you have, is that it might not be revenue-neutral, but a real revenue loser, is that correct? And, therefore, add to the budget deficit problems?

Mr. FELDSTEIN. That is correct. While it is a close call now, in terms of revenue neutrality, by the time Congress eliminates a number of features, if they don't find other sources of revenue, we are in real trouble.

Chairman LAFALCE. You talked about the investment tax credit and ACRS in previous testimony. One of the things that the Reagan proposal does is recapture unrealized gains made from the depreciation that was taken pursuant to the 1981 tax bill of the President. Have you ever heard of anything less fair than that?

Mr. FELDSTEIN. I think it is unfair, retroactively, and it has very adverse effects on the potential for investment incentive looking ahead, because how can firms ever rely upon future depreciation rules which have never been changed retroactively before?

Chairman LAFALCE. Never before.

Mr. FELDSTEIN. That is \$55 billion over 4 years, and then it finishes. It is a temporary \$55 billion revenue plug in the administration's package. I think it should be eliminated, but then Congress has to find some way of getting that \$55 billion.

If they phased in the increase in the personal exemption, going to \$2,000 in 1990 instead of \$2,000 right away, going to \$1,500 right away, and then moving to \$2,000, they would eliminate that revenue shortfall.

Chairman LAFALCE. We could discuss the tax reform proposal at least for a couple of hours, as we could this, but we all three have to go. I want to thank you.

I think this has been some of the most impressive, important testimony I have heard in 2½ years, and I am very grateful to you gentlemen.

Thank you.

[Whereupon, at 12:10 p.m., the subcommittee was adjourned subject to the call of the Chair.]

U.S. DEBT AND THE DOLLAR: THE CONSEQUENCES FOR THE STRUCTURE OF THE U.S. ECONOMY

TUESDAY, JULY 16, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ECONOMIC STABILIZATION,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2200, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Representatives LaFalce, Vento, Torres, Carper, Shumway, Dreier, and Grofberg.

Chairman LAFALCE. The Subcommittee on Economic Stabilization will come to order.

The hearing today will further examine the importance for our domestic economic health of the rise in U.S. Federal deficits, external debt, the exchange rate of the dollar, and the general deterioration of our international accounts.

At our hearing on June 20, we had a useful discussion of the fact that the United States has become a debtor nation, how we got there, and the magnitude of our indebtedness. At this hearing, we intend to delve more closely into some of the particulars of our external indebtedness and the consequences for U.S. industries. We have scheduled another hearing Thursday which will focus more on the options and limitations for monetary and fiscal policy to improve our international accounts.

From the end of 1982 until mid-1984, the Nation's overall purchasing for consumption and investment was growing at an exceptionally fast 8-percent annual rate. Many economists have attributed this exceptional demand growth to the fact that our fiscal policy was widening structural deficits at an unprecedented peacetime rate.

This was a demand tide that lifted many, if not all, boats. Although imports were supplying a rising share of U.S. domestic purchases, the Nation's production was still expanding at a remarkable 7-percent growth rate. All the while inflation was slowing.

For the last year, however, our economy has slowed. National purchasing has risen roughly 3 percent and production has expanded just over 2 percent. Thus, the 1-percent gap between consumption and production growth that is being filled by rising imports has taken on more significance.

Some sectors have been more affected than others by the surge in imports and sluggishness of exports. Many service sectors and housing have not been directly affected by international competition. On the other hand, many agricultural and manufacturing sectors have had flat or falling production—even as domestic demand for their products has been growing.

At this hearing, we intend to delve more closely into two sets of questions. First, with regard to our external indebtedness: What is the nature and extent of our foreign debt? Who is investing here? How competitive are their alternative investments? Second, with regard to the sectors of the U.S. economy: How much has the high value of the dollar hurt production in internationally traded goods and services? How much has the slowdown and decline in those sectors contributed to the overall slowdown in the U.S. economy?

We are pleased to have three expert witnesses on this subject today. Robert Ortner is Chief Economist at the Department of Commerce. David Hale is an economist at Kemper Financial Services, and Rudy Oswald, director of the research department at the AFL-CIO.

The subcommittee's distinguished minority member, Mr. Shumway from California, would like to make an opening statement.

Mr. SHUMWAY. Thank you, Mr. Chairman. Every now and then, I wonder whether Sophocles might have written the script for the U.S. economy in the 1980's. There seems to be a common threat of preordained tragedy in so many recent events. Oedipus Rex came to a tragic end, as hubris and a series of ruinous decisions led him to blind himself literally as well as figuratively.

Unlike Greek tragedies, I would suggest that the fatalism evident in our modern-day economic drama is more the fault of the collective actions of our society, rather than a single individual. Indeed, the chorus, to the king, is the key tragic figure.

We have seen how the great inflation forces of the 1970's stimulated the market response of large-scale borrowing and spending by countries, companies, and individuals. Indeed, the United States, in particular, engaged in a major borrowing and spending binge, without adequate revenues to cushion itself against the end of these forces.

In this country, those remaining in the ranks of savers demanded a fair market interest rate which compensated for inflation. When depository institutions, bound by interest rate regulation, could not meet this demand, savers took their money elsewhere. The appropriate policy response was deregulation, and regulation Q was phased out.

These market and policy responses to the great inflation tended to push up interest rates. Higher rates, in turn, triggered an important market development: the soaring foreign-exchange value of the dollar.

The mighty dollar has left its imprimatur on both our trading partners and this country. For example, LDC's that were able to borrow more dollars than they needed in the 1970's are now desperately scrambling to cut their imports and boost their exports to earn the dollars needed to service their debts. At the same time, those countries with trade surpluses have taken a substantial portion of their surplus and invested it right back here in American

securities. These two responses have had two important effects on our economy. First, such austerity programs, together with the strong dollar have swelled the U.S. trade deficit. U.S. farmers are losing foreign markets as well as their farms. U.S. manufacturers are moving overseas and taking jobs with them. The calls for trade protectionism are intensifying.

However, since foreign investors have taken up much of our burgeoning debt, we have been able to finance this debt without crowding the private sector out of the market and without raising interest rates or raising inflation. And while the demand for dollars has been tremendously adverse for American exporters, it has benefited consumers through lower prices on imports. Further, it has not affected certain interest sensitive industries, such as housing and durable goods manufacturing due to the tremendous deflationary policies now in effect.

The irony of our current drama does have its consequences. Up to now, the trade-balance deficit has helped substantially in moderating the impact of the budget deficit. This is a strange paradox, but it is one which should not generate complacency. We have beaten inflation, but at a great expense. Real interest rates remain high. The dollar is reaching its pinnacle.

Previous witnesses have stated that reduction of our budget deficit has to remain America's No. 1 economic priority, in order to avoid a tragic ending to the script. Our witnesses today have suggested other explanations and solutions to provide a happy ending. I look forward to hearing their testimony and hope that we, the Congress, can write the appropriate legislative script.

Chairman LaFALCE. We will first hear from Chief Economist for the U.S. Department of Commerce, Dr. Ortner. I advise everyone that we will put the entire text of your remarks in the record, and you may feel free to summarize.

STATEMENT OF ROBERT ORTNER, CHIEF ECONOMIST, U.S. DEPARTMENT OF COMMERCE

Mr. ORTNER. Thank you.

Mr. Chairman, members of the subcommittee, I am very happy to appear before you to discuss these problems of our international trade and our economy. The last year in which we had a surplus on our current account was 1981, and since then it has deteriorated steadily to the point that in 1984 we had a deficit of a little over \$100 billion.

The current account, I might point out, consists of several components. The main component is our foreign trade, and that is the main source of our deficit in the current account. In addition to that, there is a service sector which is primarily investment income and a third element—net unilateral transfers.

One effect of our accumulating current account deficits is that the United States net foreign investment position, that is how much assets we own abroad relative to how much assets foreigners own in this country, has been shrinking in recent years to the point that we are now becoming a net debtor nation.

I might add right there that those words may sound somewhat frightening, but that simply means, as I said before, that foreigners

at this point own more assets here than we own abroad. At the end of 1982, we had a positive asset position of about \$150 billion, and that had shrunk to about \$28 billion at the end of 1984.

There is also a large statistical discrepancy in our international accounts, and most observers feel that that discrepancy results primarily from an understatement of capital inflow into the United States. To the extent that that is true, we probably were in balance in our net investment position at the end of last year, and if not by then certainly by now, so that at this point we believe that foreign investors hold more U.S. assets than we hold abroad.

As a result of this shift, our favorable balance on asset income is also shrinking, which is not surprising. That is shown in the accompanying table at the end of my text. In 1981, when we had a surplus on the current account, we also had a surplus of \$34 billion in investment income. That is, we received more income from foreign countries than we paid out to those countries. At that point, that surplus of investment income was large enough to overcome a large trade deficit and an outflow of transfers.

At this point, our investment income balance has been shrinking so that it no longer covers our growing trade deficit and within another 2 years—and it may even be by the end of this year, our remaining surplus on asset income will also fall into deficit.

In the future, that means that in order to bring our current account into balance with this deficit on asset income, we are going to have to achieve a surplus in our foreign trade.

One issue that has been receiving a lot of attention recently is the extent to which net capital inflows have contributed to U.S. growth and the dangers that a sudden reduction of foreign capital inflows to the United States could pose for sustaining the current expansion. I think there is a great deal of confusion with regard to these questions. Many analysts have described the United States as greatly dependent for our expansion on these capital inflows as though we were sort of an international capital junkie—excuse the expression. I believe that these claims are exaggerated, and these people have failed to keep in mind an important relationship involving these accounts and that is that the current account deficit and the capital inflows are roughly one and the same thing.

In 1984, foreigners did supply about \$60 billion to our credit markets, which was up sharply from only about \$1½ billion in 1980, and that is a large amount of money. Nonetheless, that \$60 billion amounted to only about 8 percent of total credit raised in the United States last year, and that can hardly be described accurately as a dependence on foreign capital.

This foreign capital, in my opinion, could be replaced easily by domestic sources as the economy continues to expand. These foreign capital inflows, while they add to our financial resources, are also equal to our current account deficit. This current account deficit is depressing our economy because it reflects mainly the rising trade deficit. If we keep in mind that the capital inflow equals the current account deficit, it is clear that the claims that the capital inflows are helping our economy and the current account deficit is hurting our economy cannot both be right.

Why has this capital inflow increased? Since 1982, the current account movements have been dominated by our growing trade def-

icit. In fact, the increasing trade deficit has been the means by which the inflow of capital has grown. The dollar began to rise in late 1980, reflecting the shift in preferences of both American and foreign investors toward dollar denominated assets. The shift in preferences did not result in actual net capital inflow until the current account moved into deficit.

Since then, foreigners have been increasing their income in the United States by raising their exports to this country, but they have not increased their consumption here. That is, they have not increased their imports from the United States. In other words, the trade deficit and the accompanying capital inflow have in fact acted as a drag on our economy and not as a stimulus.

This result is evident in the remaining data in the table. In all the major categories shown there except for the auto industry, because of the voluntary restraint agreement, foreign producers have raised continuously their U.S. market share. Since mid-1984, imports have absorbed most of the growth in purchases of capital goods and consumer durables leaving almost no net gain for domestic producers.

The economy has slowed sharply in the past year, interest rates have eased somewhat, and the dollar has begun to fall. With the prospect of moderate growth ahead for the U.S. economy, it is quite possible that the high level reached by the dollar at the end of February or early March will prove to be the peak for this cycle. If foreign and U.S. investors now begin on balance to reduce their investment in the United States and shift part of their assets abroad, what will be the likely effects on our economy?

First, consistent with what I have already said, as a group, foreign investors probably will not succeed in reducing their capital flow to the United States very much if at all this year. A shift in their preferences away from the United States will, in fact, lower the dollar's value, but a lower dollar will raise U.S. exports and reduce imports only with a lag of a year or more, as has been the case in our economy, depending, of course, on how quickly and how much the dollar falls.

By raising import prices, which would occur as the dollar comes down, our trade balance actually will worsen at first, because imports will cost more, and it will continue to worsen until purchasers here and abroad shift the physical volume of their purchases sufficiently toward American goods. This means that the trade and current account deficits will be larger this year, and the net inflow of capital therefore will actually rise in 1985.

The net inflow of capital will not begin to shrink until the trade and current account deficits decline. A drop in the dollar would raise our inflation somewhat, as I have suggested, by raising the cost of goods that we import. How much that raises inflation, of course, depends on how fast and how far the dollar falls and other conditions in our domestic economy.

In my opinion, even if the dollar falls 25 to 30 percent, the obvious impact on our inflation rate will not be very great. A large share of our imports are priced in dollars anyway. The most notable examples are oil and automobiles. Foreign producers who have managed to increase their market shares in the United States very likely in many cases will keep their prices down even if it means

reduced profits in order to preserve their market shares in this country.

And at this time, the underlying determinants of inflation in the United States appear to me to be favorable. Growth in our economy has slowed down somewhat. The U.S. economy is operating currently about 80 percent of capacity, and wage settlements are moderate so we are not getting very much cost push on the inflation rate.

I might add, too, that oil prices are beginning to come down and that decline may very well offset all of the effects of the decline in the dollar. What about real growth? I think that here, too, there is a great deal of confusion as to the effects of a decline in the dollar.

I have heard many comments indicating that if foreigners try to pull out their investments from the United States and shift to foreign countries, this will push the dollar down, shrink the inflow of capital, and depress our economy, I think that is completely backwards. If foreigners drive down the dollar by selling dollar assets, they will eventually stimulate our economy because a lower dollar will make our own manufacturers much more competitive in the world markets.

That may not occur very noticeably within 1985, but I think within 1986 if the dollar continues to fall now, we will see a good pickup in our exports and at least a slowdown in growth of our imports. A critical question, of course, will be how the Federal Reserve reacts to these developments of a pickup in both inflation and real growth.

Currently, as a nation, we are enjoying the benefits of a high dollar—our consumers are anyway—by increasing our imports of goods and services, but our very large trade deficit represents a disequilibrium in our foreign accounts that cannot continue very long.

Eventually, the pendulum will have to swing the other way, and perhaps it has already begun to swing in the other direction. As I said before, with a deficit in asset income developing this year, and I think you will see it by the end of this year, bringing the current account into balance will require a trade surplus, and that would mean we would both have an opportunity to, and we will have to produce more than we consume.

That concludes my statement, Mr. Chairman. I would be happy to answer questions.

[The prepared statement of Mr. Ortner follows:]

TESTIMONY OF
ROBERT ORTNER
CHIEF ECONOMIST
U.S. DEPARTMENT OF COMMERCE
BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

July 16, 1985

Mr. Chairman and Members of the Subcommittee, it is a pleasure for me to appear before you today to discuss the changes in our international accounts and effects of these changes on the U.S. economy.

The U.S. current account has shifted from a small surplus in 1981 to a deficit of \$101.5 billion in 1984. The current account consists of the merchandise trade balance, military sales, the balance on services (including receipts from income on assets, travel receipts and shipping costs), and net unilateral transfers.

One effect of our accumulating current account deficits is that the United States net foreign investment position has shifted from creditor to debtor. From a peak of \$149.5 billion

at the end of 1982, our positive balance slipped to only \$29.2 billion at the end of 1984. The statistical discrepancy last year was about as large. Most analysts believe that the main source of the discrepancy is an understatement of capital inflows. If so, we may have become a net debtor at the end of 1984 or, if not then, almost surely by now.

As a result of this shift, our favorable balance on asset income is also shrinking as the Table shows. In 1981, the last year we had a current account surplus, our surplus of \$34.1 billion in investment income nearly covered unilateral transfers out of the country and a trade deficit of \$28.0 billion. Within another two years, our remaining surplus in asset income will also fall into deficit. That means we will have to achieve a trade surplus to bring the current account into balance.

An issue which has received increasing attention recently is the extent to which net capital inflows have contributed to U.S. growth and the dangers that a sudden reduction of foreign flows could pose for sustaining the current expansion. In numerous discussions of this issue, analysts have described the U.S. as dependent on capital inflows. I believe that they have exaggerated the magnitudes of these capital flows and have failed to keep in mind that the current account deficit and the capital inflows are roughly one and the same (except for statistical discrepancies).

Foreigners supplied \$59.5 billion to the credit markets last year, up sharply from \$1.5 billion in 1980. However, while the share of funds supplied to the credit market by foreign sources has grown in recent years, it amounted to only 8 percent of total funds raised in 1984. This small share can hardly be described as a dependence. The foreign inflow could be replaced easily by domestic sources. For example, although the Federal Reserve provides a relatively small amount of funds directly, it can increase the supply indirectly by holding down interest rates and encouraging domestic income and saving to rise.

Foreign capital inflows do add to financial resources. Yet, at the same time, the growing current account deficit is depressing the economy, because it reflects mainly the rising trade deficit. When one considers that the capital inflow equals the current account deficit it is clear that the claims that capital inflows are helping the economy and current account deficits hurting it cannot both be right.

Why has the inflow of capital increased? As I indicated, the net inflow of capital is approximately equal to the current account deficit. Since 1982, the current account movements have been dominated by the growing trade deficit. In fact, the increasing trade deficit was the means by which the net inflow of capital grew. The dollar began to rise in late 1980,

reflecting a shift in preferences of both foreign and American investors toward dollar denominated assets. This shift in preferences did not result in a net capital inflow until the current account moved into deficit. Since then, foreigners have increased their income in the U.S. (by raising their exports to the U.S.), but have not increased consumption (imports from the U.S.). In other words, the trade deficit and the accompanying capital inflow have acted as a drag on the economy, not as a stimulus.

The result is evident in the remaining data in the table. In all the major categories shown except autos--because of the voluntary restraint agreement--foreign producers have raised their U.S. market share. Since mid-1984, imports have absorbed most of the growth in purchases of capital goods and consumer durables, leaving almost no net gain for domestic producers.

The economy has slowed sharply in the past year, interest rates have eased somewhat and the dollar has slipped. With the prospect of moderate growth ahead for the U.S. economy, it is quite possible that the high level reached by the dollar in February will be its peak for this cycle. If foreign and U.S. investors now begin, on balance, to try to reduce their investment in the U.S. and shift part of their assets abroad, what are the likely effects here?

First, as a group, foreign investors probably will not succeed in reducing their capital flow to the U.S. very much if at all this year. A shift in their preferences away from the U.S. will lower the dollar's value. But a lower dollar will raise U.S. exports and reduce imports only with a lag of a year or more, depending on how much and how quickly the dollar falls. By raising import prices, the nominal trade balance actually will worsen initially, until purchasers here and abroad shift the physical volume of their purchases sufficiently toward American goods. This means that the trade and current account deficits will worsen this year, and the net inflow of capital will rise. The actual net inflow of capital will not begin to shrink until the trade and current account deficits do.

A drop in the dollar would raise inflation somewhat, depending on how much the dollar falls and on other conditions in the economy. Even if the dollar falls 25-30 percent, the impact may not be very great. A large share of our imports are priced in dollars, most notably oil and automobiles. In addition, foreign producers who have managed to increase their market shares in the U.S. may keep their prices down, even if it means reduced profits, in order to preserve their shares. And, at this time, underlying determinants of inflation are favorable: growth has slowed, the U.S. economy is currently operating at about 80 percent of capacity and wage settlements are moderate.

What about real growth? If investors drive down the dollar, rather than depress the economy, they will eventually stimulate it. U.S. manufacturers will increase production as our trade balance improves. A critical question will be how the Fed reacts to these developments of a pickup in both inflation and real growth. If they "lean against the wind," they will add to any rise in interest rates.

As a nation, we are enjoying the benefits of a high dollar by increasing our imports of goods and services. But this represents a disequilibrium that cannot continue indefinitely. Eventually, the pendulum will swing the other way. With a deficit in asset income, bringing the current account into balance will require a trade surplus which will mean that, for a time, we will have to produce more than we consume--working harder and enjoying it less.

U.S. International Accounts and
Their Effects on the Domestic Economy
(seas. adj., annual rate)

	1980	1981	1982	1983	1984	1985:1
Exchange value of the dollar (Dec. value) ^(a)	92.0	100.3	111.3	118.0	129.5	136.9(Mar)
Current account balance (\$bill.)	1.9	6.3	-8.0	-40.8	-101.5	-120.0
Merchandise trade balance (\$bill.)	-25.5	-28.0	-36.4	-62.0	-108.3	-117.7
Balance of receipts on income from assets (\$bill.)	30.4	34.1	29.5	25.4	19.1	10.5
Ratio of imports to final sales (1972 \$ or units)						
Capital goods except autos (%)	15.6	17.4	19.5	20.2	25.9	28.9
Consumer durable goods except autos (%)	13.1	14.2	14.5	14.9	17.3	19.9
Autos (%)	26.8	27.5	27.8	26.0	23.5	22.0
Consumer nondurable goods (%)	1.3	1.5	1.6	1.8	2.3	2.3
Growth in gross domestic purchases (1972 \$, 4th Qtr/4th Qtr, %)	-0.9	1.9	-0.4	8.0	6.7	3.4(b)
Growth in GNP (1972 \$, 4th Qtr/4th Qtr, %)	-0.8	1.6	-1.5	6.3	5.7	2.0(b)

(a) U.S. trade-weighted value of the dollar, 1980-82 =100. Morgan Guaranty Bank.

(b) Growth from 1984:2 to 1985:1 at an annual rate.

Chairman LAFALCE. Thank you very much, Dr. Ortner.

I understand you have some time constraints. Ordinarily, I would like to hear the other witnesses before we go to questions from the panel. What are your time constraints?

Mr. ORTNER. I am supposed to be back in the Commerce Department around 11 o'clock for a meeting there, which I regret.

Chairman LAFALCE. When we have hearings scheduled and we have such a time constraint, it makes it very difficult to have the type of hearing we envision.

Mr. ORTNER. I apologize for that. Part of the problem, I believe, is this occurred partly because the date of the meeting was changed a couple of times.

Chairman LAFALCE. Sure. Does anybody have any questions they would like to ask of Dr. Ortner before we go to Mr. Hale and Mr. Oswald?

I am not going to adhere to the 5-minute rule now. I think we would be better off by having different perspectives from Mr. Hale and Mr. Oswald.

Mr. TORRES. Just that in the statement, everything I have been reading is quite to the contrary. I think that Mr. Ortner has painted somewhat of a rosy picture for the future. Everything that I have heard, or, as I said, understood to be transpiring, is that we are not heading toward better times, but rather that things were getting much worse.

I am referring to this terrible debtor nation status. You say it is not frightening, and we shouldn't think of it as a frightening situation. That only means that foreigners own more in this country than we own abroad. I think that is frightening. Many of our resources and our properties, are owned by external forces and more and more the U.S. citizen in the country is owning less abroad.

You say that this is a disequilibrium that cannot continue in development. Why can we not go from bad to worse and you expect the pendulum will be swinging the other way? It just strikes me that your statement is one of a rosy future.

Mr. ORTNER. Well, I didn't think that I was painting a completely rosy picture, Mr. Torres. We do have some problems in our economy. One is that we have a large trade deficit currently which is a drag on our economy. That can improve as the dollar continues to come down and makes our industries more competitive. And the thing that I was emphasizing is that this inflow of capital, which is really our current account deficit, has not been a great benefit or blessing to us.

It has succeeded actually in depressing our manufacturing industries. Our industrial production has not grown for a year. Employment in manufacturing in general has fallen every month in 1985, at least since January. I don't think that that is a good situation. I think the pendulum has swung too far in the other direction.

As the dollar comes down, this will be of benefit to our manufacturing industries, because the high dollar has effectively priced most of them out of the market, and as this table shows and other data generally show, in all of our major industries, foreign producers have increased their market share.

At the same time as the dollar continues to fall and stimulates our economy—stimulates our own production as we become more

competitive—it will tend to raise our inflation somewhat. As I pointed out, how much it does that will depend on how much the dollar comes down and what else is going on in our own economy.

It may not be all that bad, but it is something I think we have to watch—it is a potential problem for us. I say it that way because our inflation rate at the present time is close to 4 percent. I wish it were 2 or 2½ percent, as it is in Germany. And I envy them for that and admire them for it because they have held their inflation down with a weak currency which tended to raise their inflation.

If we raise our inflation from 4 percent, we will be quickly into difficulty sometime in the near future. That is an uncertainty we have to watch. And then we have an underlying problem in our economy that we have to deal with because it has affected many other areas and that is our budget deficit. That will be a growing problem for us if we don't bring it under control in the near future.

So I think that our outlook is not bad, but it is not without problems, and I think the problems are in the direction of what I just said.

Mr. TORRES. You mentioned that you thought the projections for the future, as I have read them and have been led to understand, are perhaps largely exaggerated. I have heard recently by the end of this year, at Christmas time, because we are a debtor nation, our external debt would be \$100 billion. And if the trend continues by 1995, 10 years from now, we will owe the rest of the world \$800 billion.

Are those exaggerated statements?

Mr. ORTNER. They are not exaggerated in the sense if we continue to run deficits of \$100 billion a year, then it is very simple to multiply \$100 billion by any number of years, and that will tell you how much we will owe abroad by x year. That is a very simple calculation, and that is what will happen if we continue to accumulate current account deficits at that rate.

But I think our current account deficit is going to peak in magnitude this year. The dollar is now heading downward and next year the current account deficit is going to begin to shrink. I think we will not reach that kind of debtor position. A net debtor position, which you suggested might be \$100 billion at the end of this year, is not something that should be frightening to us. That is very small in relation to our economy.

It does represent a problem, however, and it will be a growing problem in the same sense that our budget deficit will automatically be a growing problem if we don't do anything about it. And that is that our payment of interest and dividends to foreigners representing the excess of their asset holdings in the United States will also be growing as our net debtor position continues to grow.

As I said in my remarks, to bring our current account into balance would then mean we would have to achieve a surplus in our foreign trade, and that means we will have to work harder and be more competitive.

Mr. TORRES. Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Shumway.

Mr. SHUMWAY. Dr. Ortner, I know that there are recent movements in foreign currency markets that indicate the dollar is weakening and I am sure we look at much of that as a good signal, and

that as a result, as you testified, will have an effect upon the trade balance. But other than that effect, does anyone really foresee the foreign trade imbalance to turn around soon?

There are other components of it besides the strong dollar component. Are you and other economists really predicting that those other components will likewise change so that the trade imbalance will be reversed, soon, that is, in the foreseeable future?

Mr. ORTNER. I think if the dollar continues to come down, we will see the trade deficit peaking probably late this year, or early next year. It is impossible to say exactly when. The trade deficit may very well reach a level of \$150 billion in 1985. I think maybe even a little more than that. I think it will be smaller in 1986, and that it will be trending downward. There are other factors that affect trade, of course, besides the dollar.

One important one had to do with relative growth rates. Coming out of the 1981-82 recession, we were outgrowing every other industrial country including Japan. We had growth rates, as you well know, in 1983 through the middle of 1984 of 6, 7, 8 percent, one or two quarters more than that while other industrial countries were not growing nearly as rapidly.

That means they were not increasing their imports because of growth nearly as much as we were increasing ours. So that was an important factor in our growing trade deficit along with the high dollar, which was pricing many of our manufacturers out of the markets on top of that.

As you are well aware, I am sure, there was a third problem that I might mention which had to do with the debt problems of developing countries. Because of those financial pressures they had to reduce their imports, and in many cases those imports came from the United States. As an example, our exports to Mexico, who is an important customer of ours, were cut in half between 1981 and 1983 going from \$18 billion down to \$9 billion.

This problem won't disappear overnight even if the financial arrangements are worked out. Developing nations will have to have a trade surplus with the United States in order to earn the foreign exchange they need to pay back their debts in the United States, which are denominated in dollars. So that will tend to be somewhat of a drag on our foreign trade.

Nevertheless, as we become more competitive, we ought to be able to make up for that.

Mr. SHUMWAY. That problem would be enhanced, would it not, by a lowering of the value of the dollar. In other words, the ability of these Third World nations to pay off their indebtedness is going to become—the difficulty in paying off that indebtedness will be compounded as the exchange rate swings more in our direction.

Mr. ORTNER. With a lower dollar it will be easier for them to buy dollars. It is also very helpful to them for us to get our interest rates down, which reduces the cost of service on the debt they owe us and, therefore, very understandably they share our concern with regard to lowering our budget deficit, which would help to reduce interest rates somewhat.

To the extent that we compete with them in any products, a lower dollar would be a problem for them. I think this is what you

are suggesting, but I think on balance they will be happier with the lower dollar and with lower interest rates.

Mr. SHUMWAY. Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Grotberg.

Mr. GROTBURG. Thank you, Mr. Chairman. Dr. Ortner, I am sorry I missed your full presentation, but I did read your statement. This has nothing to do with your remarks. In general, do economists agree about all of the details of our problem?

Chairman LAFALCE. No.

Mr. ORTNER. I am not aware of it if we do. You may very well hear three different lines of argument right here from—I think they will agree with me—three reasonable people, and I wish I could stay to enter the fray, but—

Mr. GROTBURG. It is an iffy business. It is very complicated.

If one has a new and rather clever idea, rather than filing a bill in Congress and waiting for the world to come to an end, who at Commerce is the one to talk to about getting at the foreign trade problem if the protectionists' drum starts beating? And they are beating. We all know that.

You represent the Department of Commerce, and I presume free trade is hanging in there as the thrust of that department. The reality is the world is going to hell on a bobsled and a lot of us are attached to that sled in our districts.

There are 535 of us who seem to know more than anybody, but I have a proposal from a constituent which makes a lot of sense. It's a new approach to foreign trade.

We all know if the Korean salaries are 10 percent of ours and the Japanese salaries are 20 percent of ours, we couldn't win that game. We've got three things: labor, materials, and taxes and profit in each country. This gets at a salary difference.

Who in your shop, Dr. Ortner, serves as counsel on trade topics? Obviously, we are not going to solve the trade problem in 6 months.

We have to have a long-range approach in stabilizing our work force against overseas trade practices.

Mr. ORTNER. As far as—

Mr. GROTBURG. I would be glad to talk with you.

Mr. ORTNER. Those of us who work in the Commerce Department, I think, work together, and I think we are pulling our oars in the same direction. I would be very happy to discuss it with you.

Mr. GROTBURG. It is not my primary responsibility. I think you know Mr. Goldrich would be personally interested in all of this. The International Trade Administration is certainly interested.

Mr. ORTNER. That depends on the kinds of issues. We are certainly interested in these problems in the Commerce Department.

If I may respond or elaborate, I don't disagree with what you have said, but I would like to point out we have had these wage differentiations in earlier years also, and it is only recently that we have been getting into trade deficits. For most of the postwar period, we have had surpluses. It is not impossible to get back into the ball game in most of these industries even though our wages are higher than they are in some countries.

We have many industries in which we can develop comparative advantages again in world markets. We have one overriding prob-

lem now which is affecting all of our industries and that is why we are losing market share within the United States. That is, for competitive purposes, the dollar is still too high. It has come down about 11 or 12 percent on what we call the trade weighted basis, that is on average against currencies of major countries with whom we trade, but that is not enough.

Most economists may agree on that point, by the way. I think that they would suggest it has to come down at least another 20 percent or 25 percent to make the bulk of our industries competitive again. We are more productive than most other economies and can compensate for the higher wages.

In fact, our advantage in productivity, which I think we can enhance in the coming years, is the means by which our standard of living will continue to be better and higher than it is in other countries. To keep our productivity growing and to make us more competitive again, we need to continue to encourage research and development of new products and new techniques, and continue to encourage capital spending because it is the stock of new capital per worker, that is the basic source of growth in productivity.

Mr. GROTBORG. I will get ahold of you.

Mr. ORTNER. Thank you. I look forward to it.

Chairman LAFALCE. The reason we decided to have the hearing on this issue is because we did see this as the primary problem. The Department of Commerce is undertaking studies of different industries and each industry might have other additional reasons above and beyond the overvalued dollar.

Some labor might not be a problem at all, and some might be. For example, in the petrochemical industry, they thought it would be a waste of time to look at the cost of labor because it is such a small component. In the brief amount of time you have been able to spend with us, I am a little confused by your testimony because I don't know quite what it said as far as the words.

I don't know whether I hear you saying that the dollar is or isn't overvalued. If it is overvalued, I don't know what you are saying is or isn't a problem. I don't know whether you are really concerned that we have entered into a net debtor status. I don't know that your concern, whatever it is for the debtor status that we have, is attributed primarily to the budget deficit or to something else.

I have more questions than I do answers in my mind after listening to your statement, primarily as to just what your own position is regarding such issues. Maybe that is my fault.

Mr. ORTNER. I will try to respond to that.

There are, I am sure, as you are aware, some problems with semantics. One of them has to do with whether the dollar is overvalued. I think I did not use that word. The dollar is a free market price, as you are aware, as it should be basically, and in that sense some people argue that it is not overvalued, and I can't disagree with that.

I was focusing on the trade deficit and domestic manufacturing, and from those perspectives the dollar is too high. It is too high to permit us to achieve a balance in our foreign trade. Basically, therefore, I personally think the dollar has been a problem. It has been a drag on our economy.

Chairman LAFALCE. Is that the position of the administration? Or don't you know the position of the administration?

Mr. ORTNER. I think that the administration recognizes that the dollar is high and that industrial output has slowed down, and that we have lost market share in the world.

Chairman LAFALCE. You said, "I personally feel that is a problem."

Mr. ORTNER. It is a problem for industrial output. Of course, that is not the whole economy. Manufacturing is 25 percent of our gross national product. Foreign investors have been buying dollar assets for a number of reasons, one of which is that our interest rates are high, and that gets back to the budget problem to some extent.

Another reason is we have a very attractive economy which attracts foreign investment. Another one that you have heard is that we are a safe haven for foreign investment. We have a very stable political system. Foreigners can depend on us. There are a variety of factors that have attracted them to invest here.

Chairman LAFALCE. You minimize the fact that we ventured into net debtor status—

Mr. ORTNER. We have barely entered into net debtor status. If it comes to \$100—

Chairman LAFALCE. You say we have barely just entered into it. Isn't it a fact we have entering into it at a faster rate than any other country in recorded history?

Mr. ORTNER. Yes; that could be an accumulating problem just as the budget deficit is an accumulating problem. I don't mean—

Chairman LAFALCE. It is a difference of perspective?

Mr. ORTNER. I think I didn't imply I liked it.

Chairman LAFALCE. You seem to be minimizing it to such an extent you almost want to create the implication that it is all right without saying anything people could pin on you. Is the net external debt we are accumulating a problem or not? I had testimony from Dr. Martin Feldstein on June 20 and Dr. Fred Bergsten, and anybody who walked out of this room at that time would have walked out with unbelievable alarm after listening to you.

I don't have the same feeling. That doesn't say they were right and you are wrong—not at all—but it is to say I am confused. For example, Dr. Bergsten said the United States is, in fact, going into external debt faster than any country in recorded history. Under the current status, the net external debt of the United States would exceed \$4 trillion by 1989.

By the end of 1985, the United States would be the largest debtor country in the world, substantially exceeding Brazil and Mexico, the current leaders. I could go on and on and on. There was considerable concern. They did think there could be a precipitous withdrawal of the foreign moneys that had financed our indebtedness, and that this could be quite alarming.

You seem to minimize it, suggesting that when you look at our credit market, it is only 8 percent. Of the total, we could easily assume that, if we could ease up our monetary policy a bit. I have a different perspective from them than I have so far from you regarding the nature and extent of the problem.

Mr. ORTNER. Well, it is hard for me to respond to what they said.

Chairman LAFALCE. I understand. Unless you have been in previous panels and discussions.

Mr. ORTNER. I saw their remarks, and in my opinion to characterize it as a disaster around the corner is a great exaggeration. If you put the question to me that way, yes, I think they exaggerated the problem. Is it a problem, however? Yes, in my opinion, it is a problem, and it will be a growing problem.

As I said before, our net international position will be in deficit by \$100 billion at the end of this year and will continue to grow each year by the same amount that we have a current account deficit. That is the amount by which foreigners will be accumulating assets in the United States, because we have to pay them for the goods that we import, and those are the assets that they accumulate.

But I think things are already turning. I think the dollar has peaked and is now beginning to come down. They will accumulate some more assets. But if you view the net international position currently and in the near future to the size of our economy, I think that looking at the actual data rather than characterizing it in qualitative terms, as I tried to do, by relating the inflow of capital to our credit market, by relating our international position to the size of our economy, at this point it is certainly not an alarming situation.

The way in which it becomes a problem would be the same for us as it is for Mexico and Brazil and other countries. Yes, if we have a \$100 billion net debtor position by the end of this year, that would be larger than the net debtor position of any of those countries, but you can hardly compare their economies with our economy; \$100 billion would be small in relation to our economy and with relation to our ability to handle that kind of debt.

I think foreign investors probably are somewhat concerned about that because they recognize that our large trade and current account deficits cannot continue indefinitely, and that as we run these deficits that means an outflow of dollars; that is, we are increasing the supply of dollars. They are concerned about that because supply and demand do work in these markets, just as they work in the stock market and the bond market. And we are building up the supply of dollars in the world markets as we run these deficits.

And that is why I say there is a disequilibrium that will not continue indefinitely. Maybe it comes down to portfolio decisions that foreigners will make with regard to the assets that they own. In any event, it appears that there is already a shift underway away from U.S. assets toward foreign assets. The dollar has come down about 12 percent, as I said, on a trade-weighted basis. I think it is going to come down more.

Our current account and trade deficit will probably peak in 1985 and then begin to shrink. I don't think that we will have trouble servicing the interest and dividends that we will have to pay on these debts because I think our economy is in good shape, and we will be competitive in the world markets once the dollar comes down to a more reasonable level.

Yes, our net debtor position is a problem, because we have to pay interest and dividends on those investments that foreigners are

holding, and we will have to produce more and export more in order to do that. I would rather see it the other way around, because when we had a surplus, as I mentioned—

Chairman LAFALCE. A larger and larger portion of our Federal budget.

Mr. ORTNER. Well, these are twin problems to some extent, and I would like to emphasize that we should get our budget deficit down in the near future. These are parallel problems.

Chairman LAFALCE. The dollar has been coming down by almost 15 percent from February to the present. It seems to be related more to the downturn in the economy than it does to the extent of the budget deficit. Is it that important that we reduce the budget deficit?

Mr. ORTNER. It is important for the reason that the budget deficit is one contributor to the level of interest rates, and reducing the budget deficit would help to bring interest rates down. It is not the whole story by any means, but it is one contributor, and interest rates are one factor in the level of the dollar.

In my opinion, there is some connection there. We should bring the budget deficit down for the sake of our domestic economy.

Chairman LAFALCE. One big difficulty I have had, and I think Dr. Hale will go into this, is that we have not been using this period of time when we have been accumulating this tremendous debt in order to enhance—when we have experienced this high dollar—the competitiveness of America's industries. So most of the investment in American interest has been in nontraded industries, as I understand it—the service sector, real estate.

Mr. ORTNER. Investment in our industry?

Chairman LAFALCE. Yes.

Mr. ORTNER. Investment in capital equipment this year was larger in manufacturing than nonmanufacturing industries according to our own survey in the Commerce Department, and I am greatly encouraged by that, including the industries that are under pressure of foreign competition. If I am not mistaken, the automobile industry is increasing its capital spending this year by something on the order of 30 percent after large increases last year. I think they are doing great in that regard.

There are two ways I guess that American manufacturing can get back into the competitive ball game. One way, of course, is for the dollar to come down so our prices will be more competitive with foreign prices. But the more that we improve our own productivity in our own industries, modernize our plants and make them more efficient, the less the dollar will have to come down to make our industries competitive. There is an interaction between these two factors.

I think that capital spending and research and development are two of the most important parts of our economy and, in my opinion, we should do everything we can to encourage it.

Chairman LAFALCE. Dr. Ortner, thank you. I know you have a time constraint. It is too bad we can't have a three-way—

Mr. ORTNER. Can I come back Thursday for your other hearing?

Chairman LAFALCE. You might do that. Thank you very much. We will now hear from Messrs. Hale and Oswald. Again, I would ask you to summarize your remarks.

STATEMENT OF DAVID D. HALE, KEMPER FINANCIAL SERVICES
INC.

Mr. HALE. Thank you very much for the privilege of speaking to the subcommittee this day.

My firm has only modest international exposure, and no exposure to the manufacturing sector. Hence, I would like you to view my comments as being from someone in the financial community concerned about long-term trends in the external financial status of the United States.

As previous speakers have pointed out, there have been ominous trends in the U.S. balance of payments during the last few years. We now have a \$130 to \$140 billion current account deficit. We are accumulating external debt at the same rate and consequently could have a \$1 trillion external debt by 1990. Even if the trade deficit stabilized, the growth of interest payments on this debt could throw up a current account deficit of 5 percent of GNP, which would be quite large by international standards.

We may, in fact, be returning to the kind of financial environment which existed in the 19th century, when the United States was vulnerable to financial crises not starting here, but starting elsewhere. In the 1830's, 1850's and 1890's, we had economic problems that stemmed, in part, from interruptions of capital flows from Britain.

I would like to stress, as the previous speaker did, that being a foreign borrower is not by itself cause for major alarm. Throughout history we have had numerous examples of countries borrowing successfully from overseas to increase their growth rates, to improve their capital stocks, and generally enjoy a higher living standard than would have been possible in the absence of foreign capital. The United States was an example of that in the 19th century.

Since World War II, we can look at Canada and Australia in the developed world, as well as Taiwan and Korea in the underdeveloped world, as examples of countries that enjoyed more investment and achieved a higher living standard than would have been possible without external borrowing.

The questions which this situation raises are first: How are we investing the money? Can we, in fact, have a higher growth rate in the future to make debt servicing payments with? Are we, in fact, generating the kind of investment that can lead to higher export income to make it possible for use to service this debt and not at some point have to cut our living standards dramatically in order to service the debt by reducing imports and consumption?

I think, unfortunately, the evidence on the investment question is very mixed. We have had in the last 2 years a significant investment boom in the United States. As my charts and tables illustrate, investment has gone to a record level as a share of GNP. But when you adjust for the impact of depreciation and the fact that a lot of this investment was in short-life equipment, the overall level of net investment has not gone to extraordinary levels. It is in line with the 1970's.

If we break it down by sector, we see that we have had a significant boom in the equipment sector, especially in cars, trucks, office

machinery, and computers. Some of this computer equipment has obviously gone to the manufacturing sector to produce more efficient plants. We have had significant computerization of many assembly operations, and we have had, in fact, a great deal of cost cutting automation in U.S. industry designed to make us more competitive with other countries.

My concern though is that if we do not have a significant correction in the dollar over the next year or two, we could see a trend in which investment becomes concentrated in nontradeable goods industries, industries which are effectively in areas like real estate and the service sector, and not affected by foreign competition.

I think the strong sectors of our manufacturing industry, and those which enjoy trade protection, and have a lot of resources will keep investing, get stronger, and remain competitive. But I would be concerned about the middle tier of industry, especially in the Middle West, which could be forced to locate overseas more often or to perhaps shift from domestic sourcing to foreign sourcing, creating a structurally expanding manufacturing trade deficit. I would hope that the Commerce Department, as well as other Government agencies, will do a great deal of work on this question because it is an area that needs research.

We have had a lot of discussion about the fact that we have had an investment boom, but I have not seen a systematic study about the quality of that investment. In fact, I would add, that we had in the last year in particular, a growing concentration of new investment in the construction area, in the real estate area. Machinery investment has dropped off in the last 9 months, and most of the growth in capital spending in the last several months has been for office buildings, shopping centers, and warehouses, as well as other areas of construction. There is still a lot of investment going on in the manufacturing sector compared to a year ago. But many management people have told me they will decrease U.S. investment in the future if they don't get more confidence that we will become more competitive as a nation again.

As a result, I think this trend poses three potential problems. First, we may not get sufficient growth in exports in the future to stabilize our trade deficit as a share of GNP. Second, we will have an expanded deficit which could, in turn, require higher interest payments in the future for foreigners that are currently projected. Third, we could if this trend continued, have a problem at some point rolling over our large external debt. A great deal of this debtor foreign investment is not in equity form, it is simply in Treasury bills and bank CD's. It has to be refinanced every few months. If we were to have a crisis of confidence, this could pose some problems.

I would stress, even if we weren't running a current account deficit, there would be a risk of this happening from time to time because the U.S. dollar plays a major international role. The U.S. dollar accounts for 75 percent of all foreign exchange reserves worldwide compared to 35 percent of world industrial output.

This is not a new problem. In 1977-78, we had a major dollar crisis with a much smaller trade deficit. But the size of the current deficit is expanding the stock of dollars in the world quite rapidly

and over time could increase the risk of a crisis if something goes wrong.

The second question we have to address is who is benefiting from our large account deficit and how will the world economy and the beneficiaries of the deficit be affected if we change our policies? I believe we basically have resolved four major problems in the short term by having rapid growth in external borrowing.

First, internally, as a nation, we have satisfied our needs for additional savings. There has been in the last 2 years, a very large rise in U.S. borrowing, both private and public, and we could not satisfy this out of domestic savings. Consequently, we had to go elsewhere for capital.

The first obvious reason for this borrowing is the large Federal budget deficit. I would add that the deficit in many cases helped to increase the tolerance of our economy for high interest rates by boosting investment without fundamentally altering personal savings behavior. As a result, we had a savings shortfall develop. This was magnified vis a vis other industrial countries by the fact that our population also tends to be younger and is growing more rapidly, so we have lots of household formation and demands for new housing, which you don't have in other countries. Germany, for example, now has a million vacant homes because of its aging population. We were probably going to become an external borrower for several reasons, but changes in Federal economic policy have magnified the trend compared to what might otherwise have occurred.

Second, I believe that our policies have helped to rescue the world from what might have been a severe economic crisis over the last few years. As you know, we have had low rates of growth because fiscal policy in other countries has been restrictive. Consequently, America has played the role of growth locomotive. Much of the world growth in the last 3 years has come from our expansionary policies. If America had not played this role, we would have, I think, a much more serious economic problem internationally. You might be holding hearings today not about the United States becoming a debtor nation, but about the problems of world depression.

Third, our large deficits have helped to rescue the LDC's from what might have been a severe financial problem over and above that caused by restrictive policy elsewhere. If we had not run down our credit by increasing our borrowing, we would have seen a much more severe set of adjustment problems in Latin America, East Asia, and among those developing countries that have to generate more exports in order to make debt servicing payments.

If you look at the growth of our trade deficit, you will see the most rapid growth has not been among our traditional partners, such as Europe and Japan, but with Latin American and non-Japanese East Asia. Our trade deficit with that group is approaching almost \$20 billion today.

Fourth, the rapid growth in our external borrowing has helped us to pay for our defense buildup. If you look at the debate we had in the late 1970's, when the dollar was weak, there was a great deal of discussion about ways to get Japan and Germany and other countries to pay more for defense. They had large economies, but

for historical reasons could not play a major role in Western defense.

There was talk about selling lots of U.S. bonds in Tokyo. In those days, the Japanese could not buy foreign securities. Well, in a sense, the marketplace has now helped to give us large-scale access to foreign savings and to help fund our defense effort. I think the fact that we are depending upon private investors rather than official agencies to fund our deficit could create a situation in the long-term where an attempt by this money to leave could jeopardize our defense effort. We may have to work out mechanisms with Japan in particular to have a permanent source of funding there, perhaps through institutions like the Postal Savings Bank, so we don't have money coming in one year and leaving the next.

Given the fact that Japan is unable or unwilling to make a large increase in defense spending, I think these kinds of informal or alternative arrangements could be helpful in developing future solutions to the problem of funding America's large budget deficits, in particular those components tied to defense.

Basically, to summarize, I think the solution to our external debt problem has to be multilateral. We cannot pursue it unilaterally. It is not just a byproduct of our policy. It has been the world's solution to a whole range of problems; the problem of the U.S. budget deficit, Western rearmament, slow growth in Europe, the Third World banking crisis. All economic policies are only a question of tradeoffs, and we have to pursue multilateral tradeoffs in addressing this issue.

I would propose three solutions in particular. First, there has to be a change in our fiscal policy, a reduction in our budget deficit, in conjunction with a change in the fiscal policies of other countries.

Many people in this country have suggested that if America cuts its budget deficit, interest rates will fall and that will solve the world's problems. I would add that other economies, Germany and Japan in particular, are not as interest rate sensitive as our own because of the aging of their population and other tax or financial rigidities, and, therefore, those countries should simultaneously have tax cuts and take other actions in order to stimulate their economies.

If America goes to a more restrictive policy, this could slow the world economy down too dramatically and create other problems with unemployment and banking. There has to be a multilateral change in world policies. We have to intensify our efforts for economic cooperation.

We have had negotiations in the last year on deregulating Japan's financial market. The effect of those was to increase capital outflows from Japan, contribute to a stronger dollar, and worsen our trade problems. We have to go back and magnify our efforts to get domestic liberalization of Japan's financial markets as well as significant tax changes to encourage more home ownership and improve their quality of life. It is extraordinary that Japan is exporting a lot of capital when only half of its homes are connected to sewers—I think there is a real set of priorities that needs to be changed. They reflect Japan's history, that of a small nation in terms of land area and natural resources, and therefore

one naturally insecure. But now that Japan is the world's second largest economy, it cannot try to play the role of Singapore, Holland, and smaller economies, as it would have 30 years ago.

Third, I think we will have to develop new mechanisms for having greater international policy surveillance so that when you have countries pursuing fiscal policies and developing savings imbalances, we can act more quickly to correct them. That is not going to be an easy task, getting cooperation among major nations, but I think we should be talking about having international treaties where a country that runs a current account surplus of 2 percent of GNP could suffer from perhaps a 10-percent import surtax until it moved closer to balance; we might also impose capital taxes on industrial nations that borrow too heavily.

There is no easy solution to this problem, but I think we need new surveillance procedures, we need new approaches to coordination or cooperation. I think that America, in particular, could play an important role by doing this with Japan and Canada. I think America and Japan are so symbiotic and complementary that if our Governments worked intently, they could develop mechanisms to give us more realistic exchange rates. I think in the case of Canada, we also have to undertake an effort to get better exchange rate coordination if we pursue the negotiations over a free trade area any further.

To summarize, I believe solutions must be multilateral. We may take action in Washington to contribute to this, perhaps to force other countries to act. But America cannot unilaterally change policy and ignore the international side effects of its actions. As we have seen in the last few years, the growth of our external debt was the function of a wide range of problems, only some of which are under our control.

Thank you very much.

Chairman LAFALCE. Thank you very much.

[The prepared statement of David D. Hale follows:]

THE U.S. AS A DEBTOR NATION:

A GLOBAL PROBLEM OR SOLUTION?

Testimony Before the Committee On Banking, Finance and Urban Affairs
Subcommittee on Economic Stability U.S. House of Representatives

Washington, D.C.

July 16, 1985

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There is increasing public concern about the economic implications of the U.S. becoming an international debtor again. As the U.S. is still the world's wealthiest nation and became a net external creditor as long ago as the First World War, it is not unnatural that this change in our international financial status should appear alarming.

Some commentators see analogies between current trends in the U.S. balance of payments and those of debt ridden developing countries in Latin America a few years ago. Certainly, by any traditional standard, recent changes in the U.S. international accounts seem ominous.

The U.S. is now accumulating external debt at the rate of \$120-140 billion per annum. By 1990, this debt could exceed one trillion dollars and be equivalent to 20% of our total national income. At current interest rate levels, this would throw up a debt servicing charge (interest payments to foreigners) as large as last year's \$100 billion trade deficit. If there is no change in the trade deficit as a share of national income, the total current account deficit could approach 5% of GNP in five years compared to 3% this year and a previous high of 1.5% in the 1870's, when the U.S. was importing capital to develop the west.

So far the U.S. has had little difficulty financing its large external deficits. Indeed, until recently, the dollar was still climbing to new highs against most of the world's major currencies. But in the long-run, the growth of such a large

external debt could add a potential new dimension of instability to our financial markets. In fact, when the U.S. was last a debtor nation in the 19th century, business cycle fluctuations often resulted from reduced capital inflows caused by changes in British monetary policy (then the dominant creditor nation). As in the 1830's, 1850's, and 1890's, changes in foreign capital inflows could once again have a major impact on U.S. interest rates, with potentially disruptive consequences for domestic business activity.

It is important to stress, though, that there is nothing intrinsically wrong with a country importing capital if the borrowing is used to finance productive investment. While dependence upon foreign capital inflows may add a new element of uncertainty to a country's financial markets, there is no inherent reason why it has to be destabilizing if the country is pursuing prudent economic policies and providing an attractive investment climate. Australia, for example, typically imports sums equivalent to 3-4% of GNP in order to finance resource development projects which subsequently generate a stream of export income to service its external borrowing. The U.S. itself was a major external borrower during the 19th century; while there were a few occasions when this rendered us vulnerable to financial crises in London, the country still enjoyed far more rapid development and a higher living standard than would have been possible without foreign investment.

As a result, any discussion of the economic significance of growing external U.S. indebtedness has to start by focusing on what the country is using its borrowing for. Are we financing a South American style consumption boom which will leave us vulnerable to debt servicing problems in the future? Are we building up a stock of capital goods which will significantly increase national output, creating greater prosperity for both ourselves and those whom we invest here?

Unfortunately, the evidence on this question is mixed. There has been a large rise in U.S. capital spending since 1982, but net investment (adjusted for depreciation) is at levels no higher than during the 1970's. Moreover, as a result of the strong dollar, the economy's growth during the past year has been increasingly concentrated in sectors which economists would describe as "non-tradeable" or basically insensitive to export and import competition. During the past twelve months, for example, the U.S. has created over 3.2 million new jobs while industrial production has been unchanged; manufacturing employment fell slightly, construction employment grew by 7%, and service employment expanded by nearly 6%. After robust growth in equipment outlays during 1983 and 1984, the strongest investment sector during the first half of 1985 was commercial construction, especially of office buildings.

While there is no way to measure the distribution of investment between tradeable and non-tradeable sectors from the Commerce Department's GNP data, the strength of commercial construction and short-life equipment sectors such as autos, trucks, and office machinery coupled with the weakness of industrial structures and machinery does raise questions about whether we are developing a capital stock suitable for generating export income in the future.

A healthy portion of the equipment expenditure boom of 1983 and 1984 probably included cost cutting automation designed to make U.S. industry more competitive, but there is no precise way of determining how much. Moreover, there have been numerous press reports recently about companies running down U.S. manufacturing facilities and relocating production elsewhere (Ford, Caterpillar, Cummins) or increasing their dependence upon foreign suppliers. If business remains pessimistic about a dollar correction, there could be a growing tendency for new U.S. investment to concentrate in non-tradeable goods industries, such as services and real estate,

while manufacturing investment could become increasingly restricted to those sectors where the U.S. has an overwhelming comparative advantage (large computers), a national security interest (aerospace) trade protection (Japanese assembly plants) or no competition (food). If this trend persisted for several years, we could enter the 1990's with an economic structure characterized by beautiful office buildings, a first class housing stock, totally automated service industries, and a highly capital intensive super efficient but very shrunken tradeable goods manufacturing sector struggling to generate the export income needed to service a trillion dollar external debt. Some service industries are becoming more important generators of foreign exchange -- insurance, education, computer software, medical care -- but it's questionable whether they can fill the export gap created by the erosion in our tradeable goods manufacturing industry during the next decade.

If money keeps flowing into the U.S. despite the deterioration of manufacturing, the economy will still be able to grow. In fact, we could probably achieve full employment as we recycled the world's surplus savings through our construction, service, and defence industries. The growth rate of productivity and real incomes would be eroded by the concentration of new employment growth in the tertiary sector, but not by as much as some media commentary has recently suggested. Average pay in the service sector is nearly \$8 per hour and construction jobs pay over \$12 per hour while the manufacturing sector pays about \$9.50 per hour. Imports are not simply moving workers from U.S. Steel to McDonald's. There is a wide dispersion of pay scales in the service sector, while the economy's strongest sector, construction, offers higher wages than either manufacturing or services.

Unlike many smaller countries, the U.S. also enjoys the advantage of borrowing in its own currency. The Latin American nations have a debt problem because they have

a large external dollar liability which must be serviced out of depreciating local currency income. The U.S. could reduce the real value of future debt service payments by devaluing the dollar.

The major problems posed by our growing dependence upon foreign savings are that (a) we may not have sufficient export growth to stabilize the current account deficit as a share of GNP since interest outlays to foreigners will rise further as we increase our borrowing (b) the growth of interest outlays to non-residents will itself drain income out of the economy whether we are enjoying prosperity or recession and (c) we could from time to time have difficulty rolling over all of our external debt if there is a loss of confidence in U.S. policy or a change in the world economy which reduces the flow of external savings into the U.S. Under those circumstances, there could be a sharp decline in the dollar, which could force the Fed to choose between monetizing more of our domestic borrowing or permitting a large increase in the level of interest rates to attract capital. As we have seen recently in the case of Australia, Britain and South Africa, capital flows would then become an important determinant of monetary policy, inflation and the economy's ability to expand.

In some respects, the dollar has always been vulnerable to a confidence problem because the stock of dollars in the world financial markets vastly exceeds what is needed to finance U.S. trade. The U.S. dollar, for example, currently accounts for about 70-80% of all global foreign exchange reserves while the U.S. itself accounts for only about 35% of OECD industrial production. As the dollar has been a major reserve currency and global financial asset for several decades, there could easily be a dollar crisis even if the U.S. had no current account deficit. Indeed, the dollar plunged during 1978 and 1979 when the current account deficit was less than 1% of GNP because of a general loss of confidence in U.S. policy that extended far

beyond concerns over trade competitiveness. Today's large current account deficit is increasing the risk of a new crisis by significantly expanding the stock of dollars in global portfolios, but there is no way of identifying the world's dollar saturation level in advance. That will depend upon a whole range of economic factors both inside and outside the United States which are in constant flux.

A Problem or Solution

The other great question which must be addressed in analyzing the U.S. balance of payments is what are the alternatives to current policies. While many Americans regard the rapid growth of U.S. external indebtedness as a potentially serious threat, it is also a solution to several other problems. Indeed, since all economic policy questions are essentially a choice of trade-offs, it is essential to explore who is benefiting from America's re-emergence as a debtor nation.

The first problem which foreign borrowing is resolving is a shortage of U.S. savings resulting from rapid growth of public and private borrowing in this country. America's voracious appetite for credit reflects several different factors. First, the U.S. has a large government deficit in both nominal and cyclical terms; it is currently about \$200 billion or 4-5% of GNP compared to less than 1% at this stage of previous business cycles. Secondly, the U.S. fiscal system provides generous tax allowances for borrowing, consumption and investment; in fact, the 1981 tax bill contributed to the current savings shortfall by significantly boosting real asset returns and encouraging a capital spending boom without fundamentally altering aggregate household savings behavior. Thirdly, the deregulation of the U.S. financial system has encouraged more aggressive promotion of domestic credit by thrifts and commercial banks. Fourthly, the population of the U.S. is younger and

expanding more rapidly than the populations of other industrial nations; hence, more Americans are borrowing to establish households while more Europeans and Japanese are starting to save for retirement. If the U.S. did not have access to foreign savings, Americans would be worrying about higher interest rates and a crisis in the homebuilding industry today rather than agonizing about the growth of our external debt.

Secondly, the world economy could not have recovered from recession three years ago without highly stimulative economic policies in the United States. Since 1982, the major industrial nations have been pursuing fiscally divergent but financially complementary economic policies. Europe and Japan have been shrinking their budget deficits in order to restrain inflation and reduce interest rates. The U.S. has been aggressively stimulating its economy through personal tax cuts, higher defence outlays, and large increases in company investment allowances. As a result of this policy divergence, the U.S. has enjoyed a magic circle of strong growth and low inflation financed by large capital inflows and a strong currency while Europe and Japan have relied on this country to provide both a buoyant export market and an attractive place in which to invest their surplus savings.

In many ways, the dollar's appreciation since 1982 has been a profit equalization process. The 1981 fiscal program significantly enhanced the return on U.S. real assets by increasing company depreciation allowances, reducing marginal tax rates, and stimulating aggregate demand. In economic theory, there cannot be a high profit sector indefinitely; capital will move into a sector until returns are equalized. In the case of the U.S., this has not merely happened through capital inflows, but also through the crowding in of foreign manufacturing capacity via the overvalued dollar exchange rate. In a floating exchange rate system, supply side policies

appear to equalize rates of return partly through currency adjustments. Indeed, it is no surprise that recent dollar weakness has co-incided with slower U.S. economic growth and falling corporate profits: the dollar's correction is part of the mechanism through which international returns equilibrate.

The U.S. has become a net external debtor because it assumed the role of world borrower and spender of last resort three years ago. If the U.S. had failed to play the role of growth locomotive, the big issue today would not be U.S. external indebtedness; it would probably be how to get out of a world depression.

Thirdly, the growth of U.S. external indebtedness has helped to rescue the U.S. banking system from a worse debt crisis in the developing world than it already faces. Our trade deficit with Latin America is now \$20 billion compared to a surplus five years ago while our trade deficit with non-Japanese East Asia is \$21 billion compared to a small deficit in the late 1970's. Without the growth in export income provided by the recent U.S. boom, many of these countries would have found it difficult to service their external debt. In fact, the growth of the trade deficit and U.S. external indebtedness is to a large extent the global financial counterpart of declining U.S. bank lending overseas. The expansion of U.S. exports to Latin America and many other developing countries during the 1970's depended upon the growth of U.S. external bank lending. Once bank lending to these countries ceased, it is not surprising that our exports shrunk and the trade deficit grew. Some analysts have argued that the U.S. is financing its current account deficit by repatriating bank loans; they have got the process upside down; the trade deficit increased partly because bank lending fell. If U.S. policy-makers had tried to reduce our trade deficit by slowing the economy in 1983 and 1984, the federal

government would not have nationalized just one major bank last year; it might have had to nationalize several. In a sense, the U.S. has used its high credit rating to sustain the growth of total world lending as credit quality declined elsewhere.

Finally, the growth of U.S. external borrowing has helped this country to find a new means of sharing the cost of western defence with its allies. In the 1950's and 1960's, the American people were able to pay for the defence of the free world partly by exporting overvalued dollars to other countries. In fact, the U.S. actually demanded that the Germans cease converting dollars into gold during 1967 as a quid pro quo for maintaining large defence forces there. Without access to foreign savings and the exchange rate subsidy, the Reagan administration would have found it far more difficult to get the American people's support for its expensive rearmament program.

Obviously, our growing dependence upon foreign borrowing creates the risk that the U.S. will return to the unilateral disarmament policies of the 1970's if the dollar falls sharply and we are unable to export debt. The only consolation is that if our allies do not increase their own defence spending in response, fear of Soviet expansionism could trigger renewed capital flight to North America, re-enthroned the dollar as the world's dominant currency, and improve the financial environment for U.S. defence spending again. In a perverse way, there is a geo-political market clearing process which tends to drive dollars back into the U.S. when American flirtation with neo-isolationism weakens western security. As in the 1950's and early 1960's, a strong dollar then reinvigorates the U.S. to improve the armed forces and more vigorously defend the free world. The problem, of course, is that we have lost large chunks of territory, albeit in marginal locations, during the downslides of past dollar cycles. While there is no way of predicting which country's security will be compromised during the next bout of dollar weakness and American neo-

isolationism, the most likely candidates are probably in south and western Asia.

When viewed from a global perspective, the growth of U.S. external indebtedness is not just a problem; it also has been the solution to several other problems -- spurring recovery from the global recession, offsetting fiscal restraint in Europe and Japan, stimulating LDC exports, financing the large U.S. budget deficit, and restoring western security. As we have seen time and again in history, though, the solution to one problem often lays the groundwork for a whole new set of difficulties later. In solving the global economic problems of the early 1980's through highly stimulative fiscal policy and rapid growth of external indebtedness, the U.S. could be storing up trouble for the next decade. There is such an unhealthy amount of foreign liquidity in the U.S. financial system today that we may reorganize our economy in potentially imprudent ways to utilize it and create a debt servicing problem for the 1990's, which could lead to a large dollar devaluation, higher inflation, and a squeeze on domestic living standards. Moreover, since this excessive liquidity appears to be encouraging an unprecedented use of leverage by U.S. firms (LBO's, hostile takeovers, junk bonds, etc.) it could significantly reduce the Fed's ability to run an effective anti-inflation policy in order to maintain confidence in the dollar. As with a fallen 1960's growth stock, the leverage which has been so beneficial to this expansion on the upside could prove highly disruptive on the downside.

Solutions

Given the global origins of the U.S. debt problem, it is essential that we seek global solutions to it.

What can be done? First, there has to be a co-ordinated program among the major

Industrial nations to reallocate fiscal stimulus from the U.S. to other countries, especially Germany and Japan. Since 1982, the only two industrial countries to pursue stimulative fiscal policies have been the U.S. and Britain; other countries have focused so heavily on reducing their budget deficits that they are now in structural budget surplus. As a result, there is considerable unused fiscal capacity for encouraging more rapid recovery elsewhere. Indeed, both Japan and Germany now have surplus savings, as defined by their current accounts, equivalent to 7-8% of GNP.

Some economists have argued that the global economy will stimulate itself if the U.S. simply reduces its budget deficit and permits interest rates to fall. While this might have been true in the past, it is unclear whether unilateral budget action in the U.S. will be sufficient to keep the world economy expanding. The Japanese economy is not nearly as interest rate sensitive as the U.S. economy because of fiscal and institutional rigidities which inhibit consumer borrowing and spending; Germany's construction sector is in a slump partly because the country's population is aging rapidly and the demand for new housing is falling; it is difficult to imagine any resurgence of external bank lending to the developing countries even if the prime rate declines to 7%. While falling U.S. interest rates will certainly give a boost to the world economy, deficit reduction in America should probably be accompanied by tax cuts in Europe as well as reforms of the Japanese tax and financial systems to make sure the world expansion stays on track.

Secondly, it is probably an appropriate moment to think about new ways of broadening Japan's international political role, especially in supporting western defence and expanding foreign aid to the third world. Japan is now planning to increase defence expenditures modestly above the traditional 1% of GNP limit, but that may be insufficient to maintain security in the Pacific if future dollar weakness leads to

significant retrenchment in U.S. defence outlays. Since the financial underpinning of our defence buildup constitutes an effective Pax JapAmericana, we might want to develop an informal understanding with Tokyo about supporting the dollar if heavy selling of it in the future jeopardizes U.S. military outlays. Since it is Japanese private investors rather than the monetary authorities whom are currently purchasing dollars, we cannot expect to repeat our 1967 experience with Germany by threatening troop withdrawals if the Japanese sell dollars. Instead, it may be necessary to develop some kind of debt recycling arrangement with a quasi-state institution, such as the Japanese Postal Savings Bank (now one of world's largest), by utilizing currency hedges to guarantee them a long-term Yen yield in return for holding a large block of non-marketable dollar debt. Japan also could give a boost to both world trade and the U.S. economy by increasing its foreign aid program; since many developing countries are now once again totally dependant upon official aid for new foreign exchange, any increased Japanese external assistance would probably have a bigger multiplier effect on the world economy than if the money was spent in Japan itself.

Thirdly, the U.S. should discuss with other industrial nations the possible creation of new international policy surveillance procedures to make sure that the domestic policy imbalances which created the recent world economic crisis do not reoccur again. The 1981 U.S. fiscal program, for example, did not raise U.S. interest rates merely by expanding the budget deficit; it also increased the U.S. tolerance for high real interest rates by enhancing the return on new investment and encouraging our already strong propensity to spend more than we save. Such a radical fiscal experiment would be perfectly acceptable in a small country, but since most of the world's external debt is dollar denominated the large increase in U.S. real interest rates had implications far beyond the American economy. The U.S. might have conducted policy differently if there had been more international awareness of what

our policies were likely to do to real interest rates and exchange rates, especially among the big money center banks which own the bulk of the world's external dollar credits.

It is always much easier to pay lip service to international policy co-ordination than to achieve it, but the fact is we have reached such a high level of global economic interdependence that we cannot avoid it. In many respects, it has become the financial equivalent of disarmament.

While it was once hoped that the floating exchange rate system would help to accommodate divergent policies and encourage optimal resource allocation based on comparative advantage, recent history suggests that it may simply magnify the micro-economic distortions already embedded in domestic economic policies. Should the U.S., for example, be exporting manufacturing jobs to an overcrowded and polluted chain of Asian islands, where per capita incomes exceed \$11,000 per annum but only half the homes are connected to sewers, so that its workaholic citizens can generate a savings surplus which is then recycled back across the Pacific via the Treasury debt market to subsidize the building of more vacant office towers in Houston and Los Angeles?

While the U.S. and Japan have a symbiotic financial, trade, and military relationship, it is doubtful whether their current policy mix is encouraging optimal resource allocation. Indeed, since the two countries now have one of the world's most pivotal trading relationships, the best way to get the OECD group moving towards greater policy co-ordination may be for Japan and the U.S. to repeg and then stabilize the Yen/Dollar exchange rate at a more commercially realistic level, much as Germany and France have done through the European monetary system. A serious effort in this direction would not merely involve currency swaps and financial

recycling; it would ultimately encourage the two countries to move towards economic convergence by borrowing the best of each other's tax policies and financial practices. Greater co-ordination of economic policy with Canada also will be necessary if this country signs a free trade agreement with her northern neighbor. At present, many U.S. businessmen, especially in the timber industry, believe that Canada is pursuing a cheap exchange rate policy in order to capture market share here. If the two countries are to have a free trade area, it also may be necessary to have a full fledged currency union, or at least a currency target zone tolerable to industry in both countries. Aside from enhancing trade, a currency union might also help Canada to lower her domestic interest rates and reduce government spending through lower debt servicing costs. While there is no way to define what constitutes an optimal currency area, it is doubtful that Canada, alone, can be considered one. Indeed, there are a lot of analogies between Canada's recent problems with inflation, budget deficits, and debt servicing costs and those of Ireland following its withdrawal from the British monetary system in the late 1970's. Just as Ireland found it much easier to borrow when it enjoyed the financial and exchange rate status of a large English county, so might Canada enjoy lower interest rates and a healthier financial climate if it were to become the "13th Federal Reserve District" on an informal basis.

Needless to say, greater global policy co-ordination also would help to correct the tremendous void which has developed during recent years in U.S. international economic policy. After over-emphasizing external trade competitiveness at the expense of inflation during the 1970's, the U.S. naturally shifted back to a strong dollar policy during the early 1980's. But in 1983 and 1984, U.S. international economic policy was dominated to an unhealthy extent by ideological rhetoric about the benefits of freely floating exchange rates and Treasury pre-occupation with flogging bonds to foreigners.

As it became apparent during 1983 and 1984 that the dollar was seriously overvalued on a commercial basis, the U.S. Treasury responded to industry complaints with homilies about the efficiency of the exchange markets; it said nothing about the macroeconomic policies driving capital flows within those markets, except that currency appreciation was a sign of virtue. In 1984, the Treasury actually encouraged the dollar's appreciation by abolishing withholding taxes on foreign owned U.S. bonds and introducing bearer instruments for non-residents. Under similar economic circumstances in 1978, Switzerland imposed negative interest rates on foreign owned bank deposits in order to slow the appreciation of the Swiss Franc and protect Swiss manufacturing industry. In effect, U.S. international economic policy last year was dictated by our perceived need to sell more debt to foreigners. Other considerations, such as trade competitiveness, simply fell by the wayside. Indeed, at his final press conference as Treasury Secretary Donald Regan bragged that he had sold more debt than any of his predecessors. There has always been an ambiguity in U.S. policy about the dollar's dual role as a national currency and international reserve asset. But seldom in American history have commercial interests been so completely subjugated to financial interests. The only historical analogy which comes close is Britain's return to the gold standard at an overvalued exchange rate in the 1920's, a move designed to reassert London's supremacy as a world financial center. In the case of the U.S., though, post-1982 government policy was not designed to strengthen New York's role as a financial center; it was instead designed to enhance Washington's status as the world's biggest borrower.

Fortunately, Treasury Secretary James Baker's recent comments about the dollar suggest that the U.S. government is now trying to pursue a more balanced international economic policy, with greater attention to the country's commercial interests and not just to the Treasury's bond marketing efforts.

In summary, the re-emergence of the U.S. as a debtor nation is the cumulative by-product of a series of a global policy imbalances which started during the 1970's and intensified during the first half of 1980's. It was the means by which the international system adjusted to U.S. budget deficits, divergent OECD fiscal policies, a collapse of international bank lending, structural rigidities in the Japanese economy, and a reassertion of American military power.

There is no simple way to respond to such a complex multilateral adjustment process. Obviously, the U.S. must start by getting its own house in order through reduced federal government budget deficits, but unlike Japan, we must not complacently assume that thrift will be its own reward. There has to be a co-ordinated effort to produce more growth oriented policies in other countries as the U.S. retrenches as well as a basic reform of the way in which the U.S. conducts international economic policy to assure a better balance in the future between our global commercial and financial interests.

While they are attracting increasing support in Congress today, trade quotas, import sur-taxes, and capital controls are not real remedies to our international ills; they address symptoms rather than causes and could worsen such problems as the LDC debt crisis. It is easy to understand why there is a growing constituency for controls and import sur-taxes. In a world where capital flows have become so large and seemingly unpredictable, there is a natural tendency to seek refuge from them behind protectionist walls. But it is not possible to correct the failings of the exchange rate system by creating new distortions in the flow of real goods and services. Those must be addressed through improvements in the whole structure of economic policy-making and greater international harmonization of the policy variables which actually determine capital flows. As in 1971, the U.S. could use the import surcharge as a tool to bargain for changes in foreign economic policy

which support this objective, but before the U.S. starts down such a potentially dangerous path, we should be very certain that we understand our objectives and do not ultimately confuse means with ends.

In fact, with technology reducing the importance of traditional resource endowments as determinants of national output, all the industrial nations may now be locked into an inexorable march towards greater harmonization of tax and financial regulatory policies in order to attract investment and preserve an open trading system. While fixed exchange rates died ten years ago because policy makers lost control of the financial forces which determine them, the 1990's may be a period in which the world returns to exchange rate stability not through intervention but by more carefully managing the economic factors which actually determine capital flows between the major industrial nations.

David Hale

CHART APPENDIX TO TESTIMONY

OF

DAVID HALE

Testimony Before the Committee On Banking, Finance and Urban Affairs
Subcommittee on Economic Stability U.S. House of Representatives

Washington, D.C.

WHY THE DOLLAR ROSE

CHART 1

General government financial balances^a
 Surplus (+) or deficit (-) as percentage of nominal GNP/GDP

	1979	1980	1981	1982	1983	1984 ^b	1985 ^b	1986 ^c
United States	+0.8	+1.2	+0.9	+3.8	+4.1	+3.4	+3.7	+3.8
Japan	+4.8	+4.5	+4.0	+3.8	+3.5	+2.6	+1.4	+0.5
Germany	+2.7	+3.1	+3.8	+5.4	+2.8	+2.3	+1.5	+1.3
France	+0.7	+0.2	+1.8	+2.7	+3.1	+2.8	+3.2	+3.4
United Kingdom	+3.2	+3.9	+3.2	+2.3	+3.5	+4.0	+3.6	+2.9
Italy	+8.5	+8.0	+11.9	+12.6	+12.4	+13.5	+17.1	+13.1
Canada	+1.8	+2.7	+1.8	+5.0	+6.2	+6.4	+6.0	+5.5
Total of above countries ^d	+1.7	+2.4	+2.8	+4.0	+4.3	+3.8	+3.7	+3.5
Australia	+1.5	+0.6	0	+0.4	+4.1	+3.7	+2.9	+2.7
Austria	+2.4	+1.7	+1.6	+3.1	+3.4	+2.2	+1.7	+1.3
Belgium	+7.0	+8.6	+14.1	+12.6	+13.4	+11.8	+10.3	+9.5
Denmark	+1.9	+3.3	+6.9	+9.3	+7.5	+4.5	+3.0	+1.8
Finland	+0.5	+0.5	+1.1	+0.4	+1.5	+0.1	+0.7	+0.2
Greece	+1.9	+4.9	+9.6	+8.1	+9.5	+10.5	+11.0	+10.8
Netherlands	+4.0	+4.0	+5.4	+7.0	+6.1	+5.7	+5.6	+6.1
Norway	+1.8	+6.8	+5.4	+5.3	+4.5	+6.3	+2.5	+2.4
Spain	+1.7	+2.0	+3.0	+5.3	+1.3	+5.0	+4.5	+4.2
Sweden	+3.0	+3.7	+4.9	+6.3	+4.9	+3.6	+3.0	+2.5
Total of smaller countries ^e	+2.4	+2.4	+3.7	+4.8	+5.3	+4.4	+4.1	+3.8
Total of above countries ^f	+1.8	+2.4	+2.7	+4.1	+4.4	+3.9	+3.7	+3.5

a) On a NNA basis except for the United States, the United Kingdom, Greece and the Netherlands which are on a national income account basis.

b) OECD countries and territories.

c) 1982 GNP/GDP weights and exchange rates.

¹ There has been a sharp divergence in OECD fiscal policy, which has created a savings shortage in the U.S. economy and savings surpluses in Europe and Japan.

Chart 1

Changes in U.S. Private Claims and Liabilities to Private Foreigners
(Billions of dollars)

Change in	1981	1982	1983	1984
1. U.S. PRIVATE ASSETS ABROAD (Increase +)	-101	-108	-91	-111
ADJUSTMENTS				
2. Netherlands Antilles (inflow +)	-1	-8	-6	-10
3. IMF Claims on Foreigners (inc. +)	61	78	29	11
4. Net Claims of Banks in the United States on their IBFs (200+ +)	-18	-8	4	-15
5. ADJUSTED U.S. PRIVATE ASSETS ABROAD	-49	-48	-54	-105
6. Direct Investment, adjusted 1/	-17	-12	-18	-21
7. Foreign Securities	-9	-8	-8	-10
8. Other Nonbanks	-1	7	-5	4
9. Bank Claims on Foreigners, adjusted 2/	2-194	2-141	171	-
10. Claims on Nonbanks 3/	-11	-9	-11	5
11. Other Claims	-18	-14	11	1
12. ALTERNATIVE MEASURE: U.S. PRIVATE ASSETS ABROAD (Sum lines 5, 7, 8, and 11)	-31	-31	-21	-14
13. FOREIGN PRIVATE ASSETS IN U.S. (Increase +)	74	81	74	80
ADJUSTMENTS				
14. Netherlands Antilles (inflow +)	3	9	4	4
15. IMF Liabilities to Foreigners (200+ -)	-14	-17	-32	-14
16. ADJUSTED FOREIGN PRIVATE ASSETS IN U.S.	63	73	46	70
17. Direct Investment	23	13	11	11
18. U.S. Treasury Securities	9	7	9	22
19. Other Securities 4/	30	25	12	17
20. Other Nonbanks	1	-2	-1	4
21. Bank Liabilities, adjusted 5/	2-17	2-41	1179	114
22. Liabilities to Nonbanks 6/	4	3	3	7
23. Other Liabilities	-6	-9	12	7
24. ALTERNATIVE MEASURE: FOREIGN PRIVATE ASSETS IN U.S. (Sum lines 17, 18, 19, 20, and 21)	41	58	37	71
MEMO:				
25. Net Bank Other Claims and Liabilities 7/	-34	-43	22	8

1/ Inflows from finance affiliates of U.S. companies in the Netherlands Antilles through the 1st quarter of 1984 have been excluded from direct investment outflows (line 6) and added to foreign purchases of U.S. securities (line 19) because they are largely the result of Eurobond sales.

2/ Bank claims and liabilities have been adjusted to exclude claims and liabilities with respect to foreigners on the books of IBFs (lines 1 and 15). In addition, approximate changes in net claims of banks in the United States on IBFs (line 4) have been added on the claims side. This adjustment series, while necessarily somewhat arbitrary, permits rough comparisons of 1981 and 1982 with subsequent years, but does not permit comparisons with earlier years, because some of the assets and liabilities at the IBFs would have been booked at U.S. rather than offshore offices if IBFs had not been created.

3/ Banks' own claims on foreign public borrowers and other nonbanks, denominated in dollars, - adjusted roughly for shift in assets from domestic offices to IBFs (\$21 billion in 1981 and \$5 billion in 1982).

4/ Banks' own and custody liabilities (other than U.S. Treasury) to foreign private members - nonmonetary international and regional organizations, denominated in dollars.

5/ Includes transactions with affiliated and unaffiliated banks, custody claims, and claims and liabilities denominated in foreign currencies, as well as the difference between net claims of banks in the United States (line 4) and the selected shift in claims on foreign nonbanks from domestic offices to IBFs.

6/ There was also a sharp decline in U.S. bank lending after 1982 which both contributed to the growth of the trade deficit while also making it easier for the U.S. financial system to accommodate rapid growth in public and private sector borrowing.

[TABLE 1]

Cross-country comparisons of contributions to GNP growth¹

Countries and periods	GNP	Foreign sector			Domestic sector				
		exports	imports	net foreign balance	total domestic demand	private consumption	public investment	public consumption	change in stock building
		changes as a percentage of GNP in the base period							
United States									
1962 to 1966 to previous period	12.4	4.1	- 3.2	- 2.9	14.9	6.7	3.7	3.5	2.8
	12.7	5.1	- 3.6	- 2.5	11.2	6.4	3.6	1.4	1.1
Japan									
1962 to 1966 to previous period	10.6	6.2	- 1.7	4.9	6.2	2.6	0.0	3.6	0.4
	16.6	7.3	- 2.8	2.4	16.4	9.0	2.9	4.5	0.6
Germany									
1962 to 1966 to previous period	6.0	4.7	- 3.1	1.6	6.0	3.6	1.0 ²	1.4 ²	1.0
	10.2	4.9	- 3.6	1.2	6.0	6.6	1.0 ²	1.0 ²	1.0
France									
1962 to 1966 to previous period	2.9	2.7	- 1.1	1.6	1.0	0.6	0.2	- 0.2	1.0
	10.9	2.9	- 0.1	1.2	10.1	6.6	1.1	1.6	1.6
United Kingdom									
1962 to 1966 to previous period	6.4	2.6	- 0.6	1.6	7.2	2.7	1.0	1.6	0.8
	5.8	3.7	- 2.9	0.8	6.0	1.7	1.0	1.2	1.0
Italy									
1962 to 1966 to previous period	2.9	4.3	- 4.3	0.1	2.6	2.0 ²		0.6 ²	
	12.1	4.3	- 2.2	2.1	10.0	7.4 ²		2.6 ²	
Canada									
1962 to 1966 to previous period	11.1	9.0	- 1.6	1.6	9.6	6.1	0.9	- 1.4	3.6
	11.2	4.1	- 5.3	- 1.2	12.4	7.2	1.5	0.3	1.5
Sweden									
1962 to 1966 to previous period ³	6.6	4.3	- 0.6	3.9	0.9	- 0.4	0.7	0.6	0.6
	7.6	6.0	- 5.0	0.0	7.6	1.9	1.5	0.2	3.0

¹The system whereby is compared with the average performance in the corresponding two year period of three previous periods. For all countries except Sweden the first of these previous periods was used to start from the second quarter of 1957. Sweden, fourth quarter, 1957. The starting dates for the second year: United States and Canada, fourth quarter, 1957; France, second quarter, 1957; Japan, third quarter, 1957; Germany and Sweden, fourth quarter, 1957; United Kingdom, first quarter, 1957; Italy, third quarter, 1957. For the third year the starting dates were: United States, Canada, Japan, Germany, France and Italy, second quarter, 1967; United Kingdom, third quarter, 1966. ²A minus sign denotes an increase in imports. ³Excludes public investment. ⁴Includes public investment and residential construction. ⁵Including changes in stockbuilding. ⁶Two points only.

† As a result of policy divergences, U.S. domestic demand has grown rapidly while other countries have depended much more on export growth.

CHART 4

JAPAN: THE CURRENT ACCOUNT AS A PROPORTION OF GNP

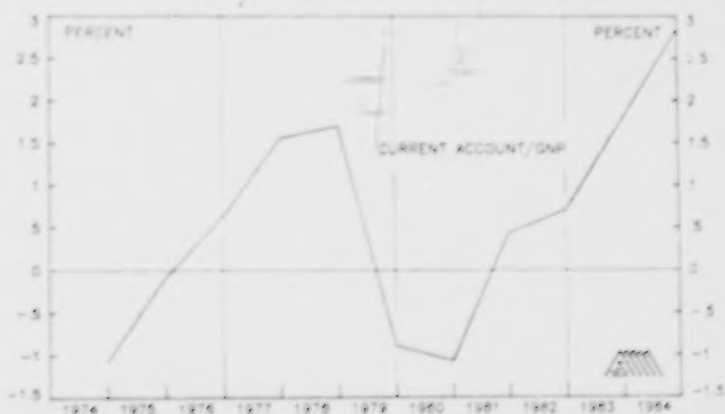
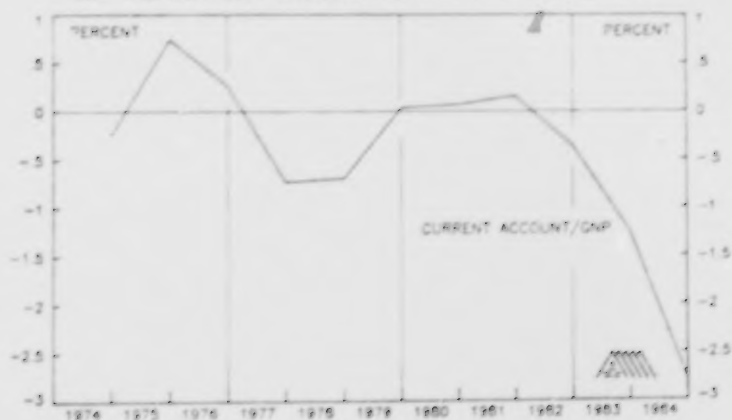


CHART 5

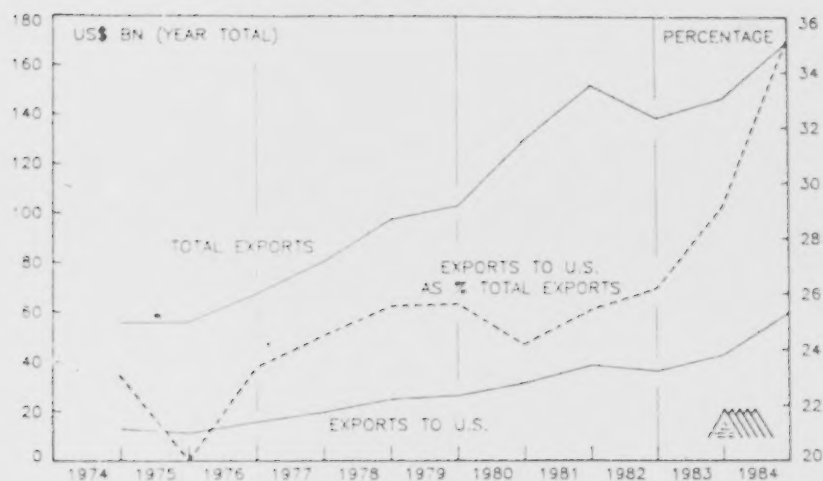
US: THE CURRENT ACCOUNT AS A PROPORTION OF GNP



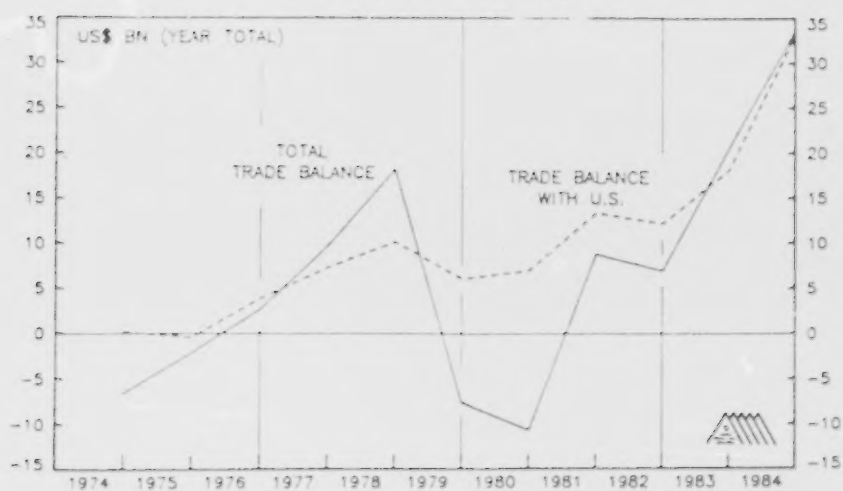
One of the major reasons for the Dollar's strength has been the symbiotic trade and financial relationship between the U.S. and Japan. Not coincidentally, the two countries' balance of payments are practically polar opposites of each other, with Japan loaning us much of the money needed to pay for purchases of its exports.

CHART 6

JAPAN: JAPAN'S EXPORT PERFORMANCE



JAPAN: JAPAN-US TRADE



Japan's exports have boomed since 1982 because of American demand.

CHART 7

JAPAN: GROWTH RATES OF REAL GNP AND DOMESTIC EXPENDITURE

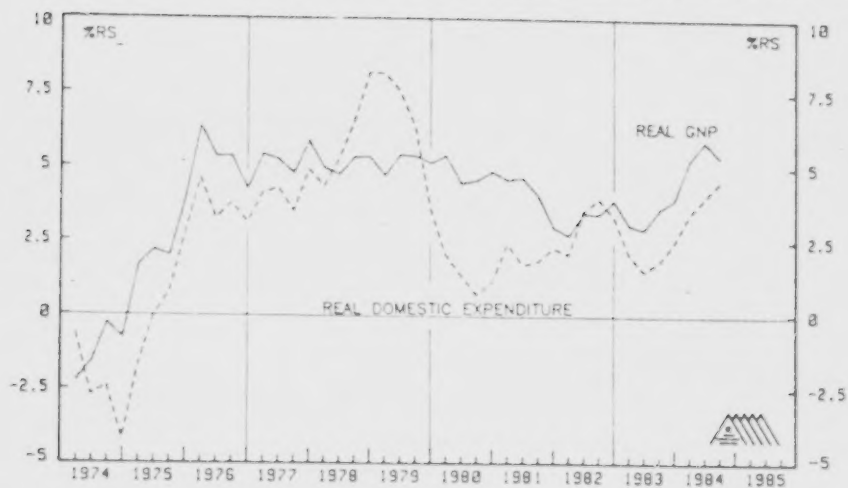
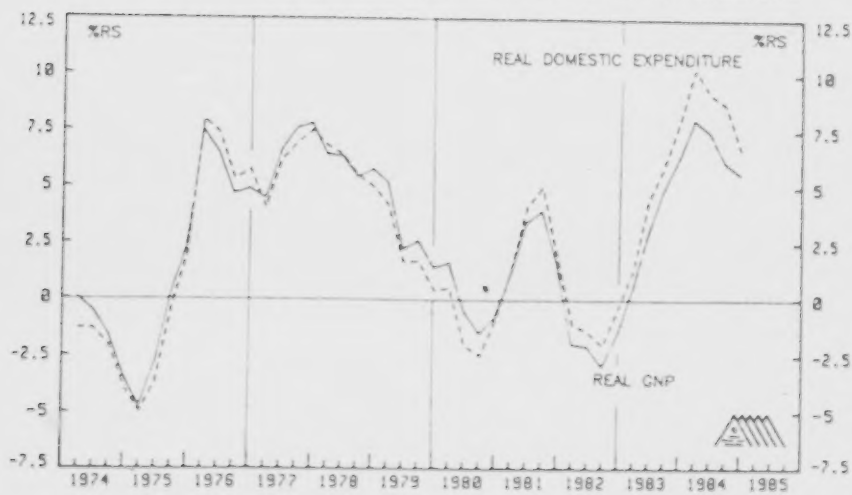


CHART 8

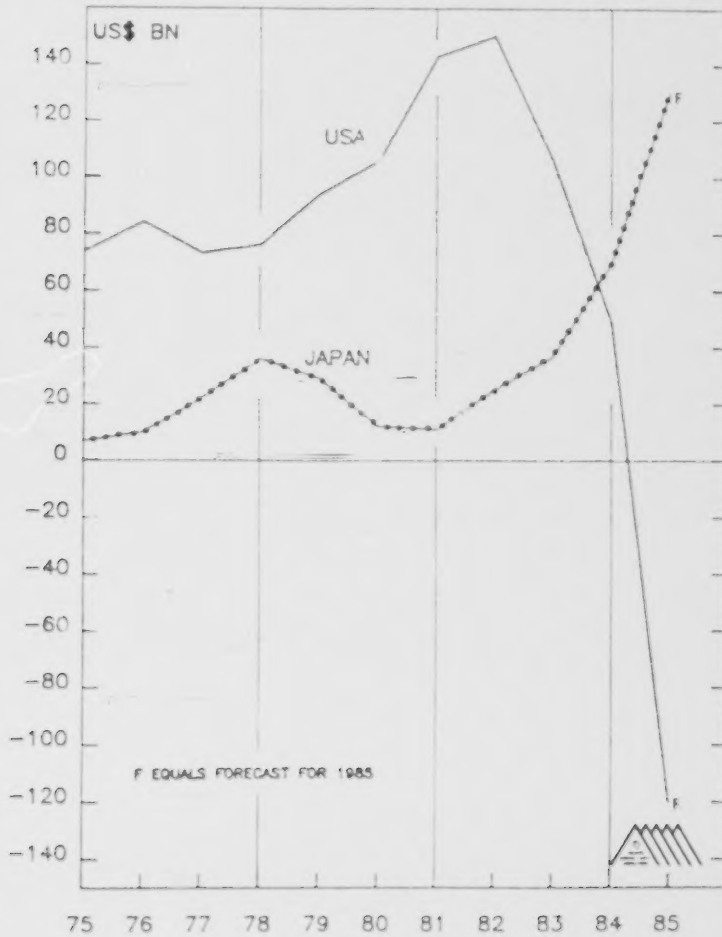
US: GROWTH RATES OF REAL GNP AND DOMESTIC EXPENDITURE



As a result, Japanese GNP has grown more rapidly than domestic demand while the reverse has been true in the U.S.

CHART B

THE US AND JAPAN: DEBTOR AND CREDITOR NATIONS
NET ASSETS OF US AND JAPANESE RESIDENTS HELD ABROAD



SOURCE: "SURVEY OF CURRENT BUSINESS" MINISTRY OF FINANCE, JAPAN

This year, the U.S. will become the world's largest debtor nation while Japan will become its largest creditor nation.

TRENDS IN THE CURRENT ACCOUNT AND TRADE DEFICIT

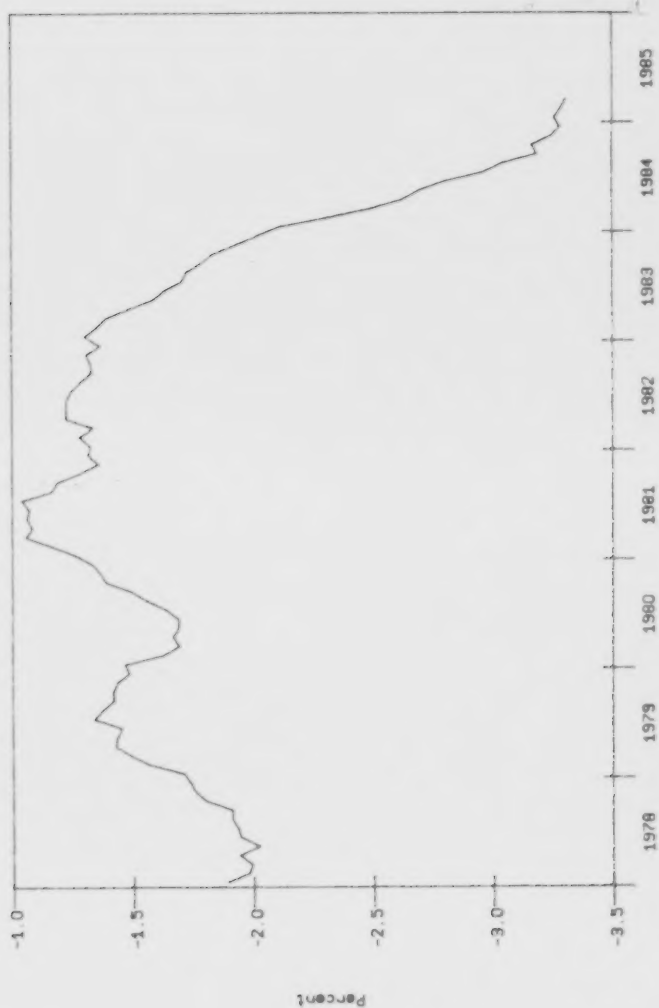
ANNUALIZED CURRENT ACCOUNT BALANCE AS A SHARE OF GNP



4 quarter moving average

The current account deficit is now at its highest level since the 1970's and still expanding.

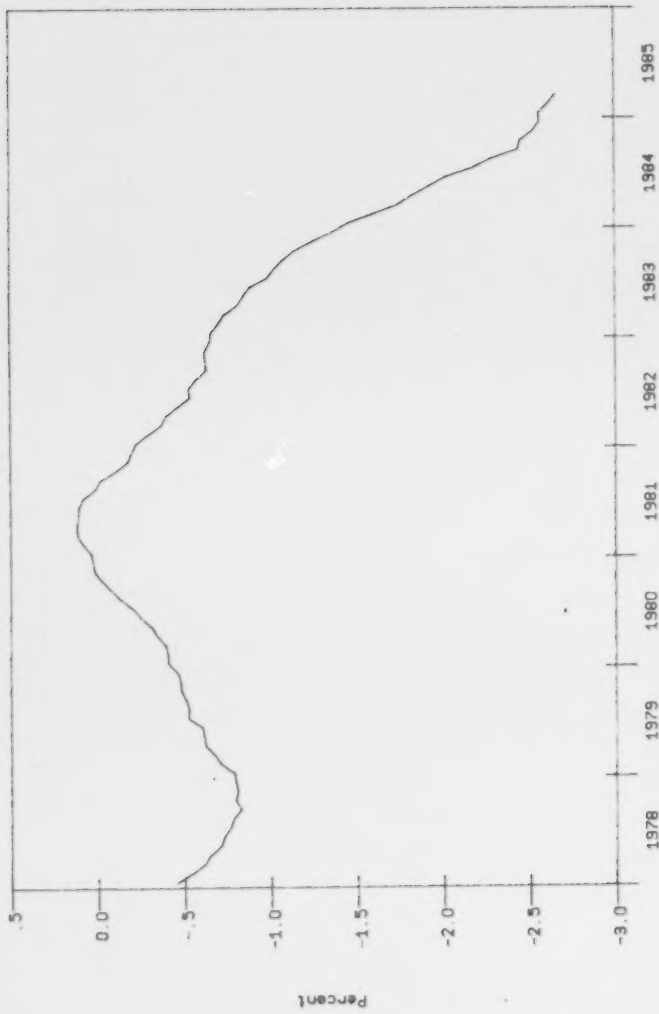
CHART 1
MERCHANDISE TRADE BALANCE
AS A SHARE OF GNP



12 Month moving average - annualized

This reflects a large deterioration in merchandise trade

MANUFACTURING TRADE BALANCE
AS A SHARE OF GNP

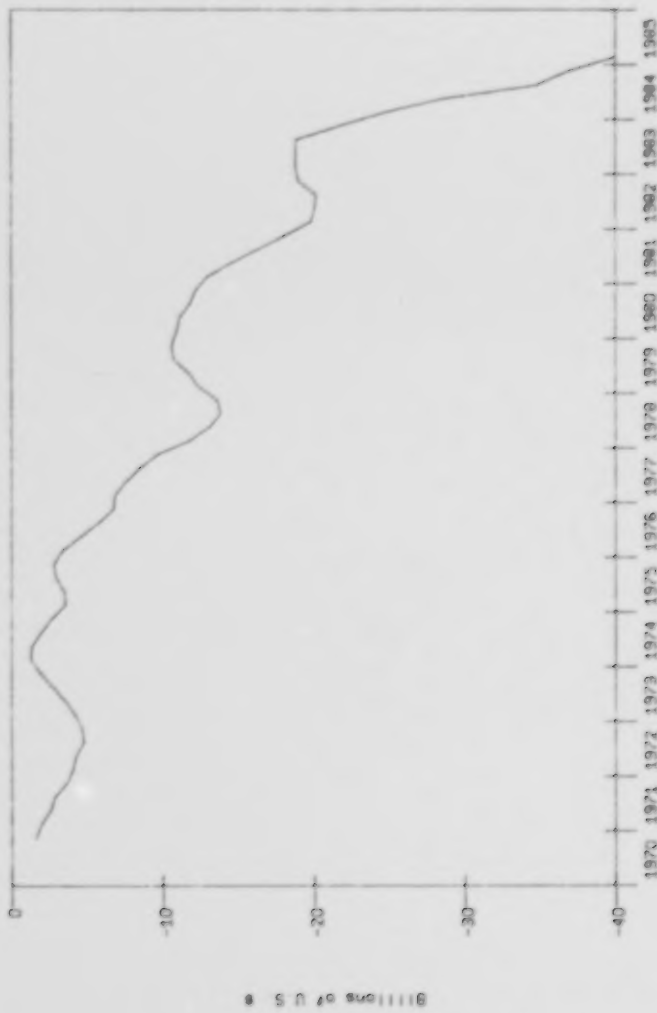


12 Month moving average - annualized

..... resulting from a deterioration in manufacturing competitiveness and rapid growth of imports.

ANNUALIZED TRADE BALANCE

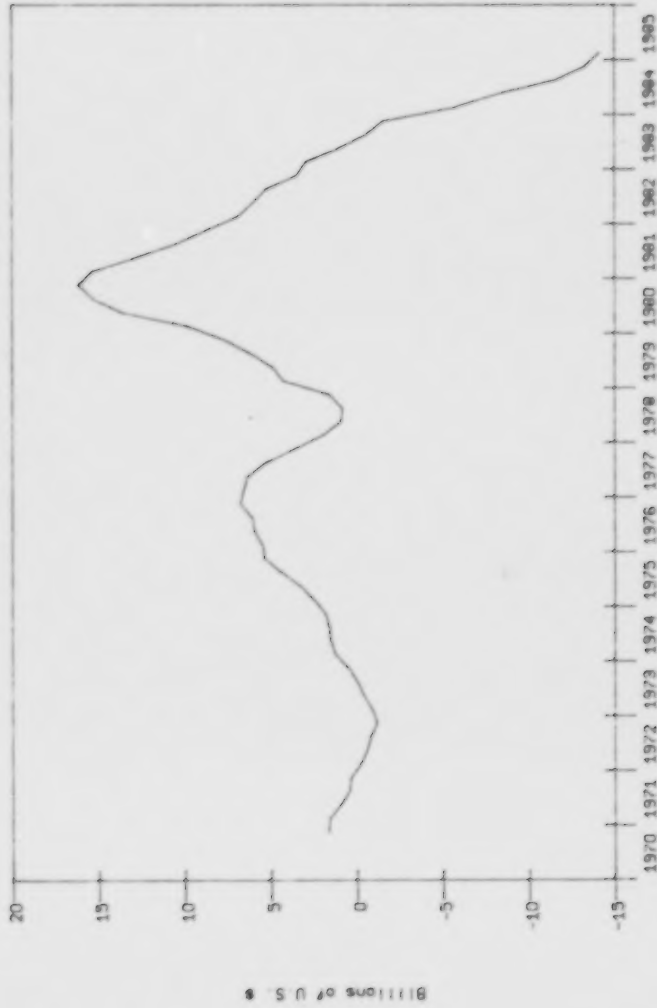
U.S. - JAPAN



4 quarter moving average

The trade deficit with Japan is approaching 40 billion.

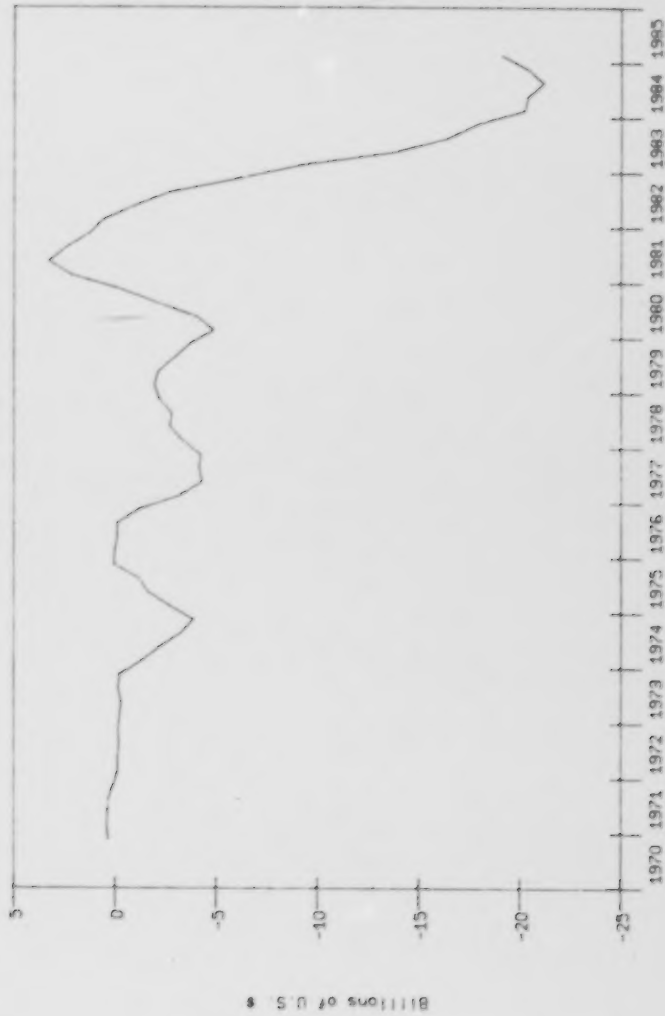
ANNUALIZED TRADE BALANCE U.S. - EUROPE



4 quarter moving average

But the biggest change in the trade account has been with Europe, where we now have a \$15 billion deficit compared to a \$16 billion surplus five years ago.

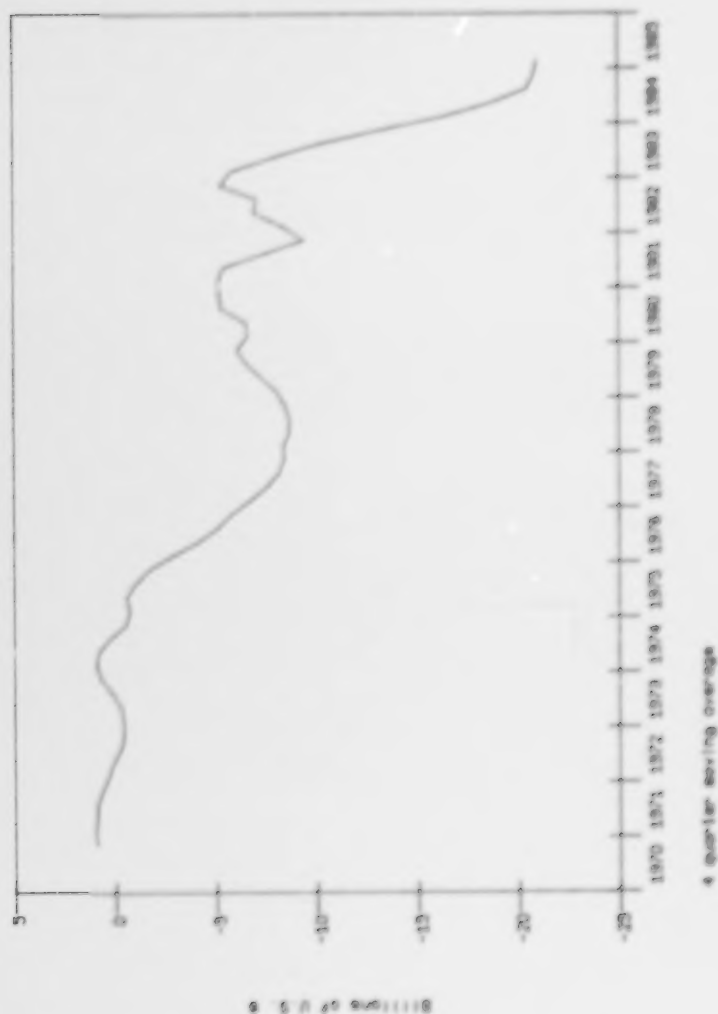
ANNUALIZED TRADE BALANCE
U.S. - LATIN AMERICA



4 quarter moving average

The same trend is apparent in Latin America, where there is now a \$21 billion deficit compared to a surplus in 1981.

CHART 15
ANNUALIZED TRADE BALANCE
U.S. - ASIA & AUSTRALIA (Less Japan)

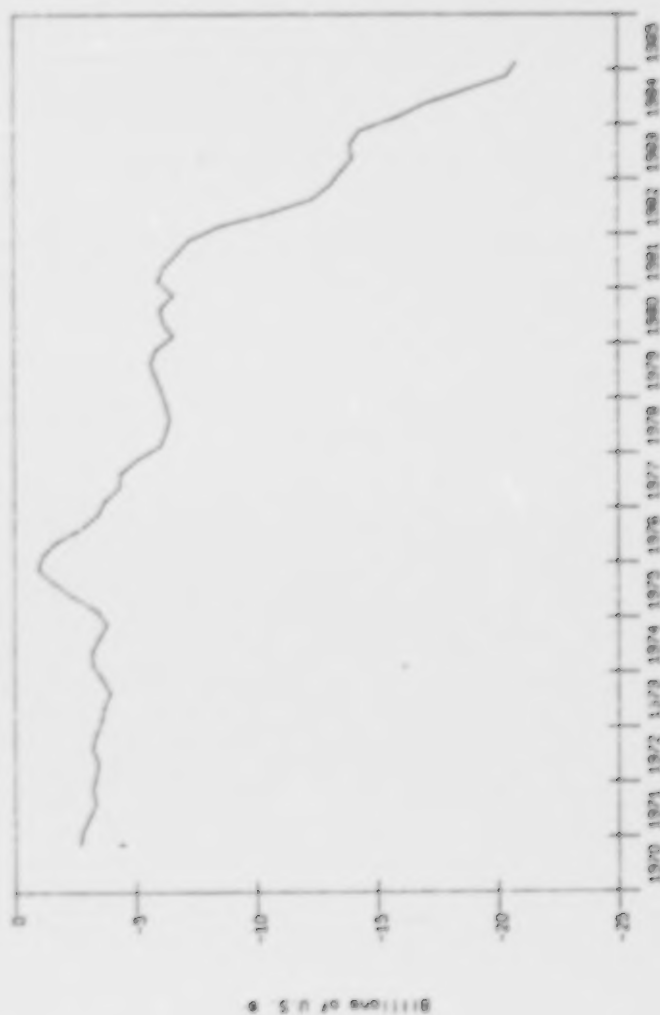


The trade deficit with non-Japanese East Asia has climbed from \$5 billion to \$17 billion.

Figure 4

Imports, 1970-1993 (billions of U.S. dollars)

U.S. - Canada

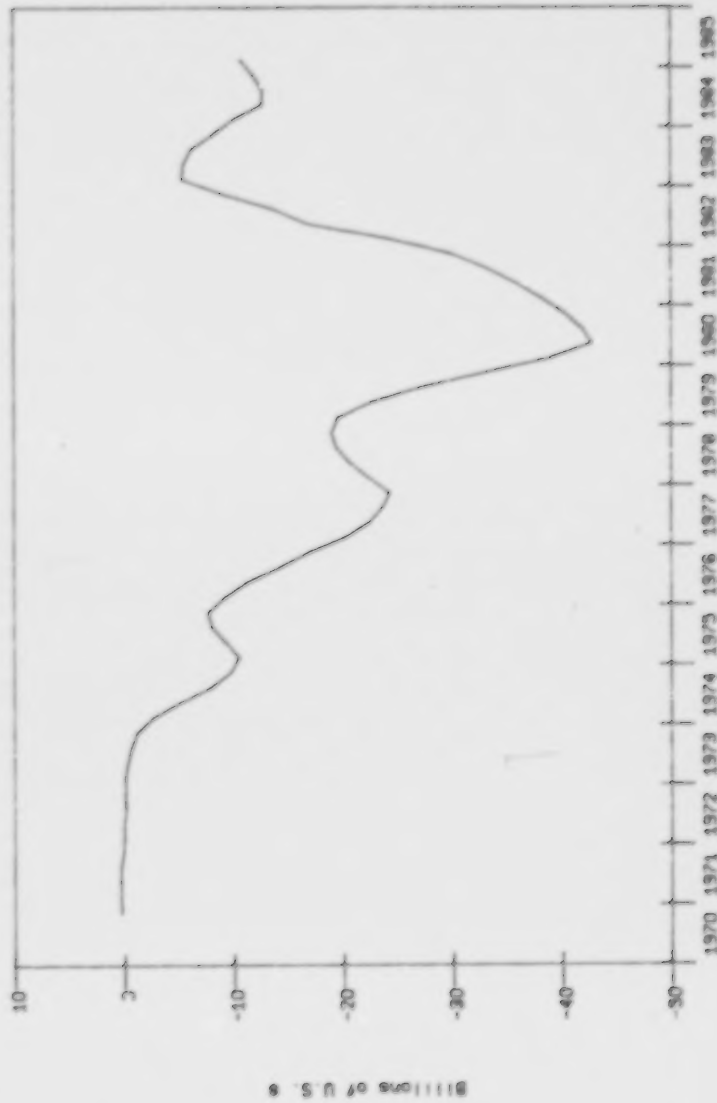


4 quarter moving average

Imports also has declined 2% trade surplus

ANNUALIZED TRADE BALANCE

U.S. - OPEC

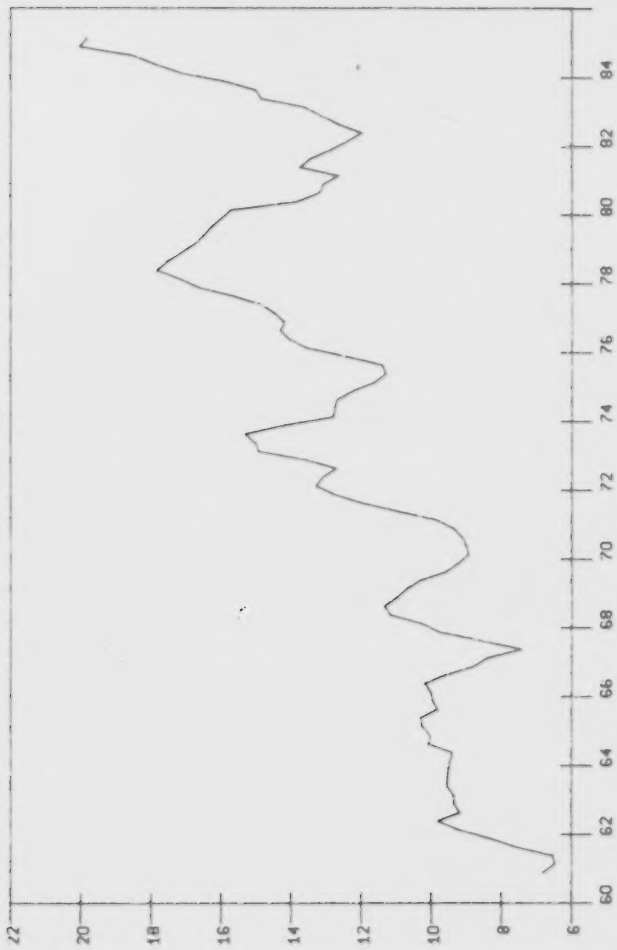


4 quarter moving average

The only dip in the U.S. trade account is with OPEC.

WHERE HAS ALL THE MONEY GONE?

CHART 18
TOTAL FUNDS BORROWED
AS A SHARE OF GNP



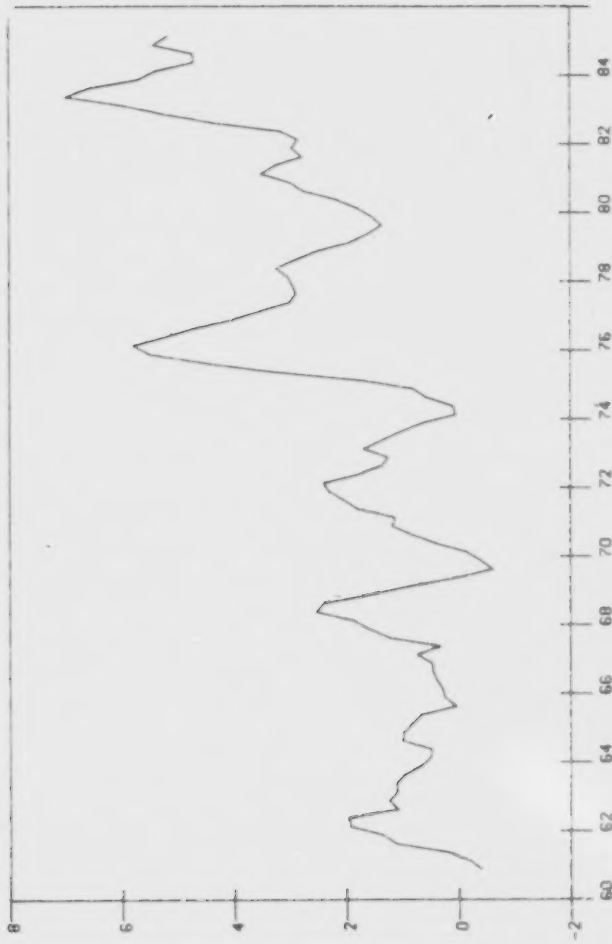
Source = Flow of Funds

4 qtr. moving average

There has been a boom in U.S. borrowing during the past few years both in absolute terms and relative to GNP.

CHART 19

FEDERAL GOVERNMENT
AS A SHARE OF GNP

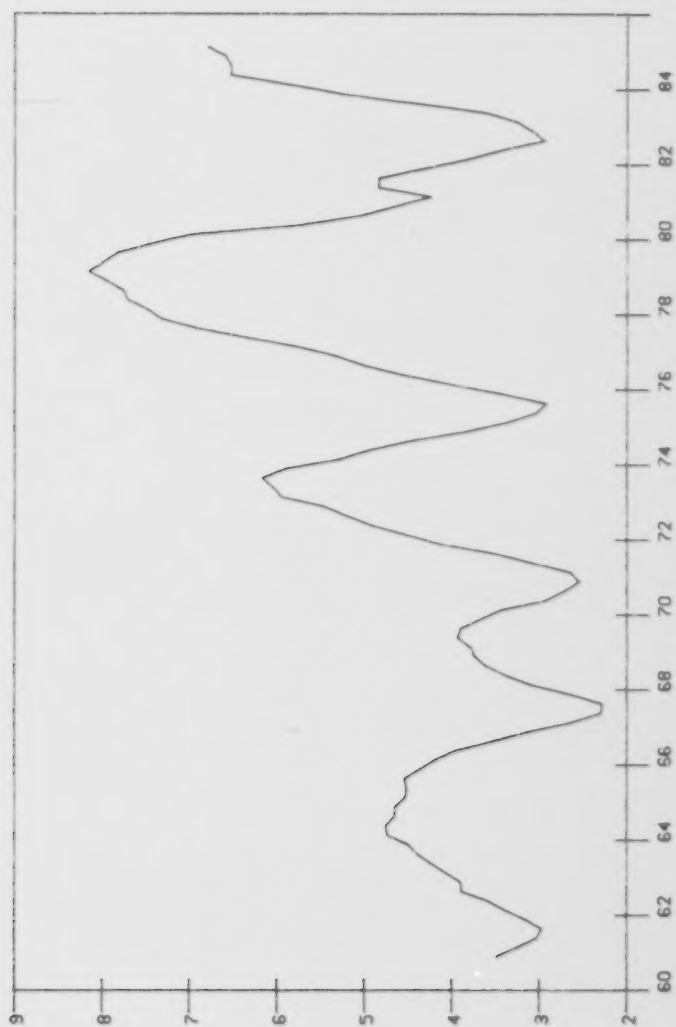


Source = Flow of Funds

4 qtr. moving average

The government deficit is at a high level for this stage of the business cycle.

CHART 20
HOUSEHOLDS
AS A SHARE OF GNP

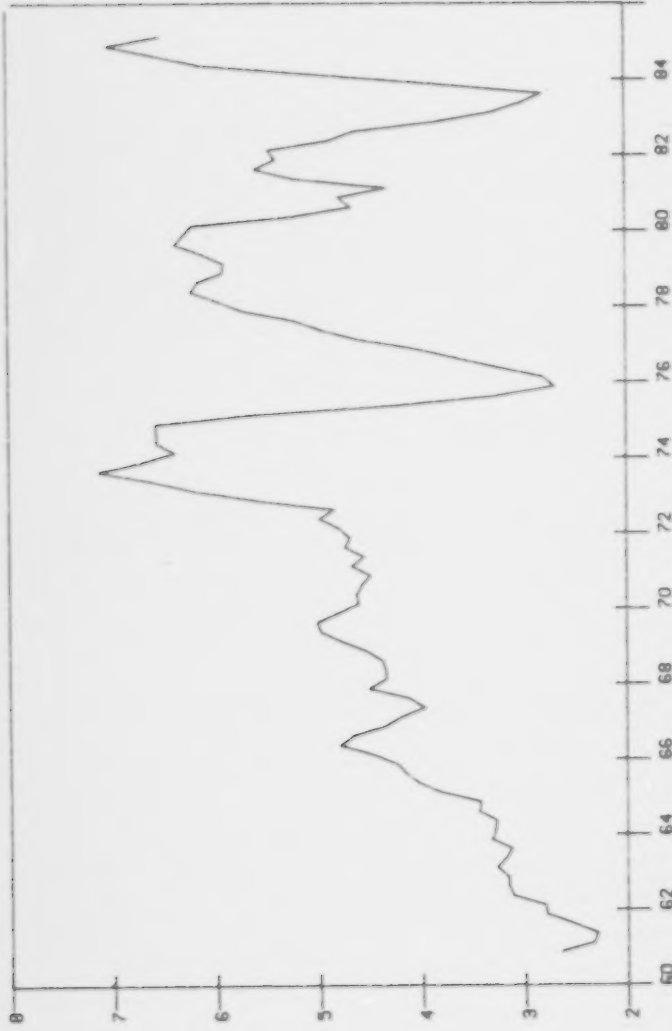


Source = Flow of Funds

4 qtr. moving average

Consumers are still borrowing heavily despite high interest rates.

CHART 21
NONFINANCIAL BUSINESS
AS A SHARE OF GNP



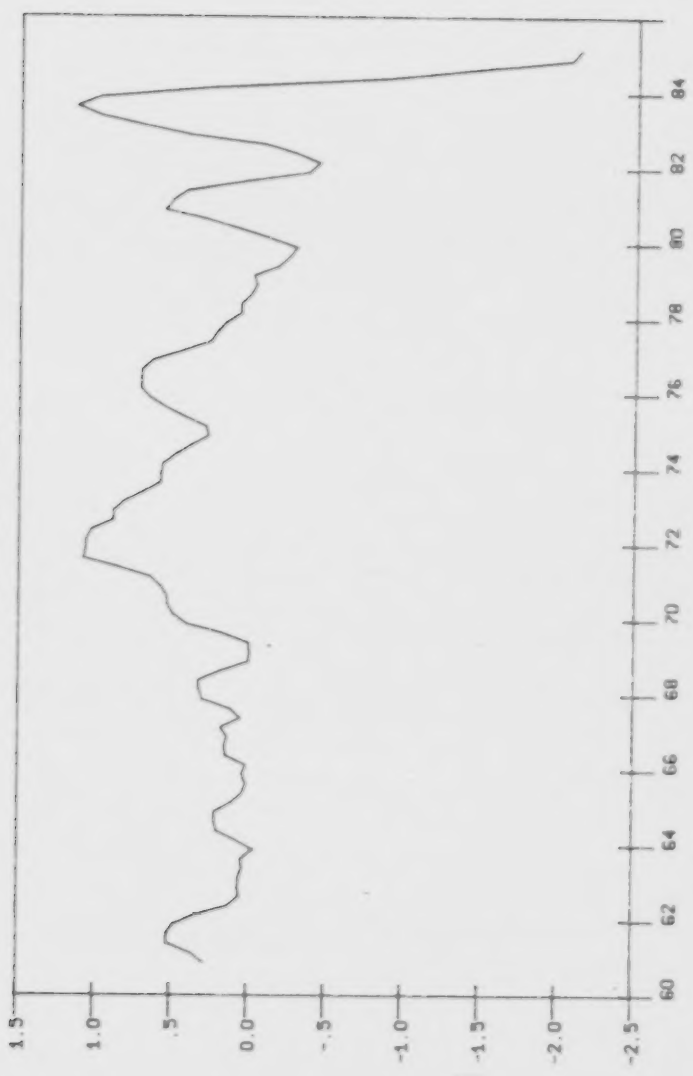
Source = Flow of Funds

4 qtr. moving average

Business also has been a big borrower to fund growth.

CHART 22

TOTAL EQUITY RAISED
AS A SHARE OF GNP

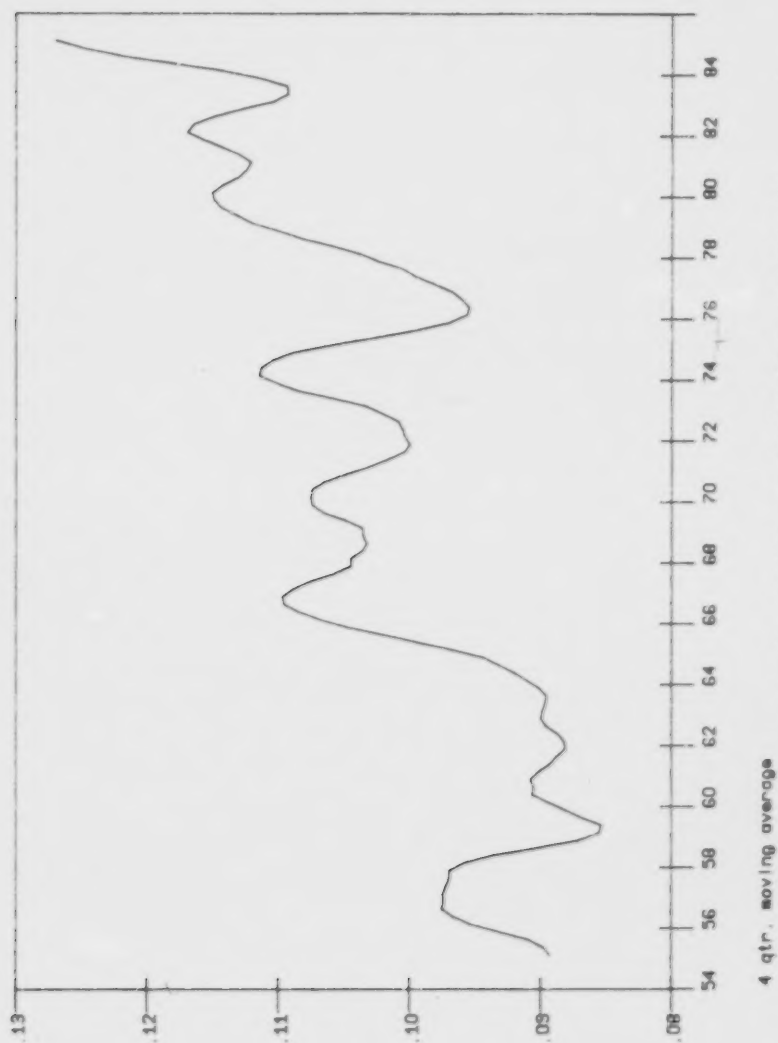


Source = Flow of Funds
4 qtr. moving average

and also to convert equity into debt through leveraged buyouts and takeovers.

CHART 33

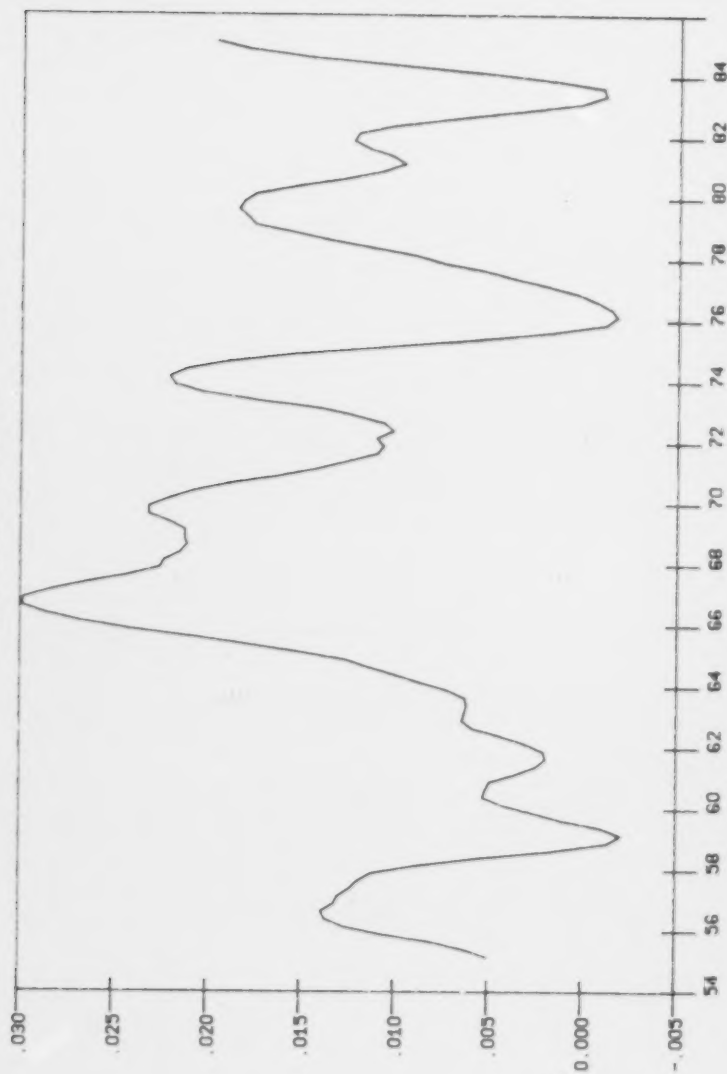
REAL BUSINESS FIXED INVESTMENT
AS A SHARE OF REAL GNP



Capital spending rose sharply during 1983 and 1984.

REAL BUSINESS FIXED INVESTMENT - (Less Depreciation)

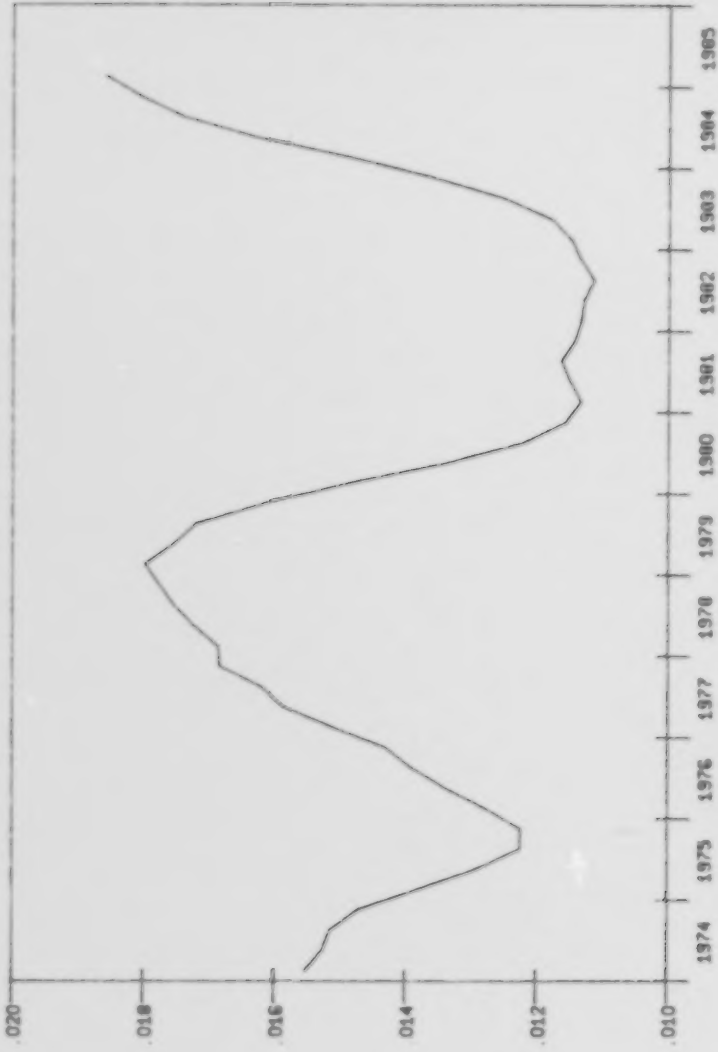
AS A SHARE OF REAL GNP



4 qtr. moving average

But since much of the growth was concentrated in short life assets with high depreciation rates the growth of net investment has been more modest.

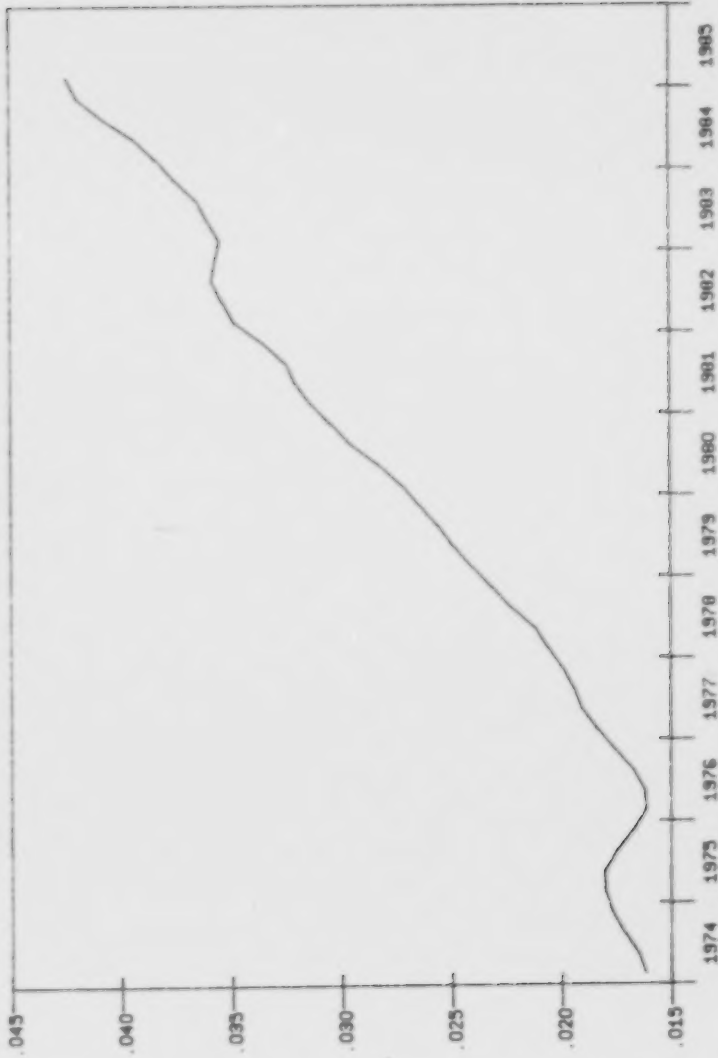
TABLE 2
REAL AUTO & TRUCK INVESTMENT
AS A SHARE OF REAL GNP



4 qtr. moving average

As in past cycles, there was a sharp uptick in transportation equipment outlays.

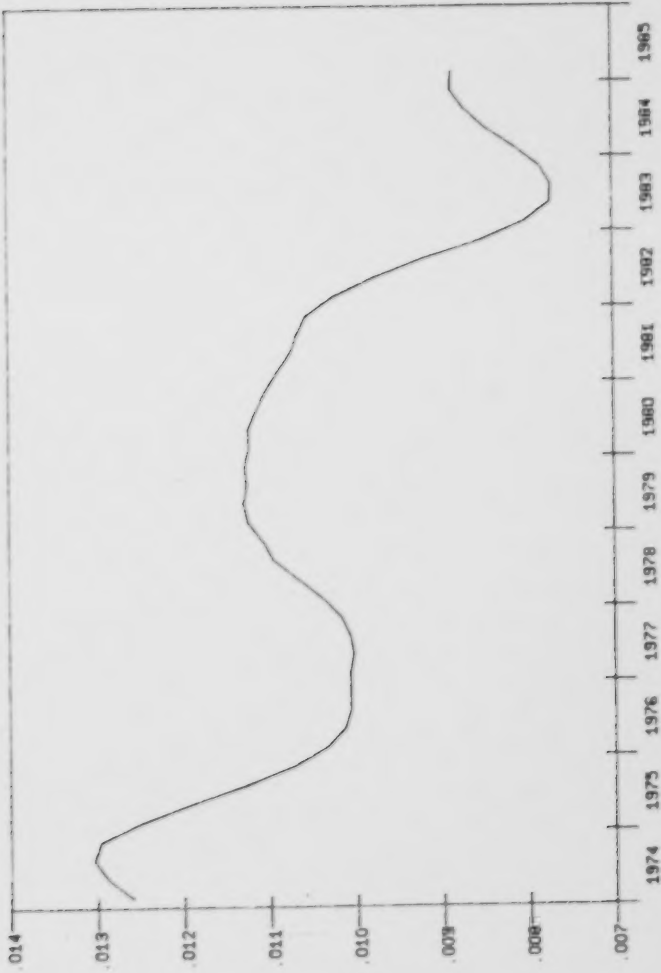
REAL HIGH TECH EQUIPMENT INVESTMENT
AS A SHARE OF REAL GNP



4 qtr. moving average

The high technology sector (office machinery, communications, computers) remains on a fast growth track.

REAL INDUSTRIAL MACHINERY INVESTMENT
AS A SHARE OF REAL GNP

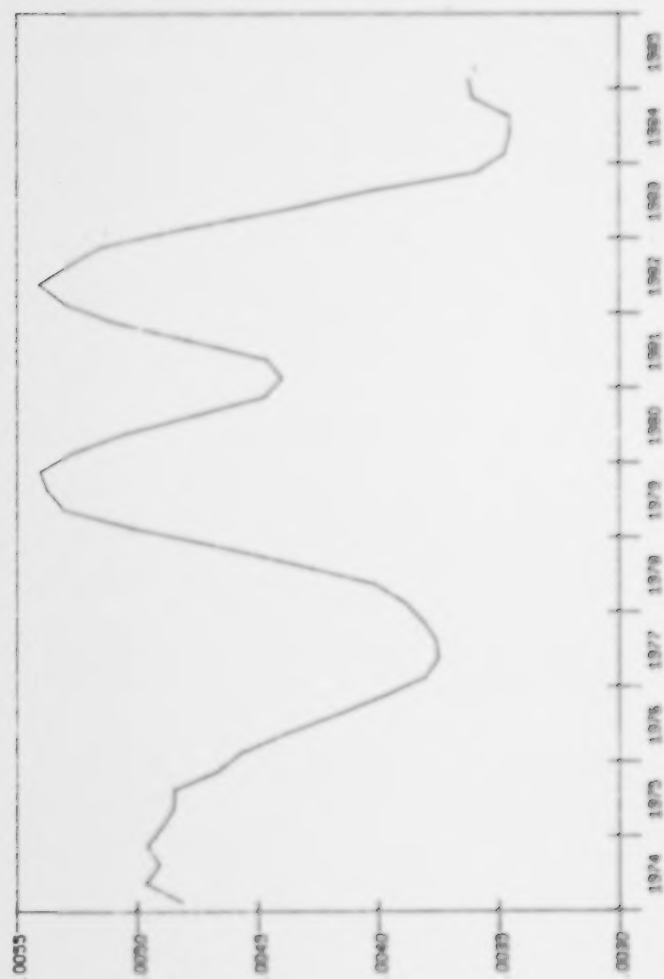


4 qtr. moving average

Traditional industrial machinery has lagged compared to previous cycles.

CHART 76

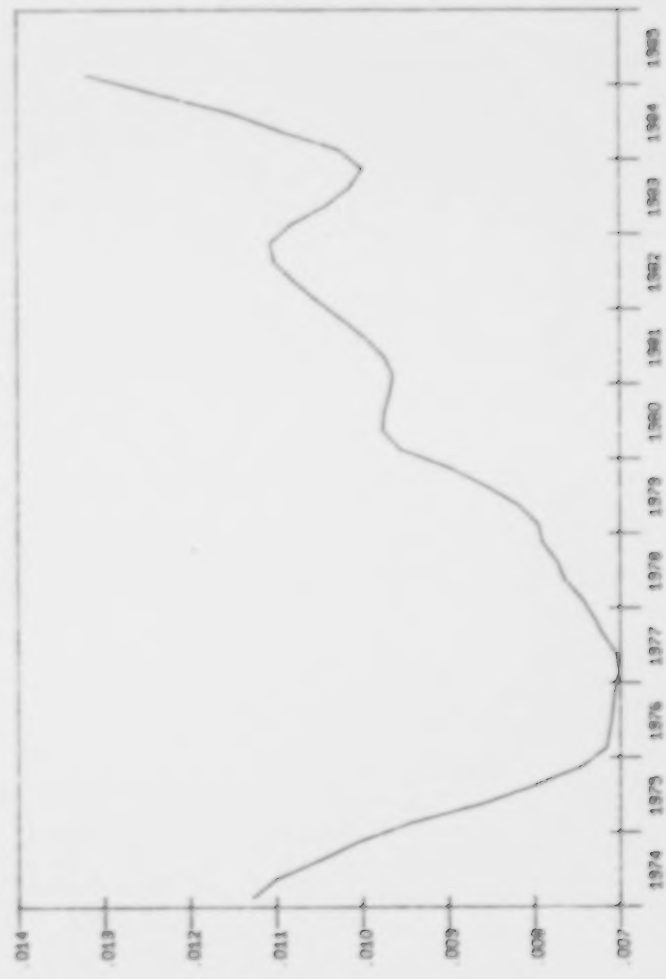
REAL INDUSTRIAL STRUCTURE INVESTMENT
AS A SHARE OF REAL GNP



4 qtr. moving average

The ratio trend also is apparent in new spending on industrial structures.

REAL COMMERCIAL STRUCTURE INVESTMENT
AS A SHARE OF REAL GDP



4 qtr. moving average

But new investment in office buildings, shopping centers, and warehouses
if new imports had climbed to 1980 levels.

Chairman LAFALCE. Before questions, we will hear from Dr. Oswald.

STATEMENT OF RUDY OSWALD, DIRECTOR, DEPARTMENT OF ECONOMIC RESEARCH, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. OSWALD. Thank you.

I would like to summarize my statement and also put it somewhat in perspective of the other speakers you have had this morning. First of all, in terms of Dr. Ortner's comments about the decline in the value of the dollar and its movement of 10 to 12 percent, what he failed to say is that still leaves the dollar approximately 10 percent above the levels of 1 year ago, so that in that perspective, we can anticipate trade deficits that are related to the overvalued dollar will still be in the \$120, \$130 billion range in 1986, 1987, unless there is continued substantial decline in the value of the dollar from even its current level, and there is no indication that this will take place.

He emphasized the decline in the Federal budget deficit as being a major interrelationship, but what he also failed to say in that regard is that even with the budget cuts that are being proposed for the 1986 budget, the level of the deficit will be approximately the same level that it was in the 1984 budget. So that we can anticipate substantial problems from that sort of element.

In that respect, I would like to emphasize a little bit of what took place in 1984 in particular industries. If you look at what has happened to computing equipment, you now have what was supposed to be our high tech area, 17 percent of all elements are now imported in the computing equipment area, 31 percent in metal cutting machine tools, 34 percent in semiconductors, 48 percent for motorcycles, bicycles and parts, 75 percent for fine earthenware, 78 percent for women's handbags, purses. I mention these to indicate that a wide variety of U.S. industries are being disseminated by the impact of trade.

Mr. Ortner did talk a little bit about the decline of employment in manufacturing since January of this year. What he didn't do is indicate the magnitude. Employment in manufacturing in this country has decreased over 200,000, 220,000 since January of this year. And since July 1981, before the last three recessions started, employment in manufacturing was down by 1 million.

I would also like to put into some other perspective a little bit of his dialog with Mr. Grotberg in terms of free trade and the overvalued dollar and wages. When one looks at what has happened to the value of the dollar, the increase of approximately 70 percent since 1980, an increase that has been going up at a rate of almost 15 percent a year for each year for the last 5 years, in order to get back to the same playing ground we were in in a competitive position of 1980, workers would have had to reduce their wages by 15 percent a year each and every year. Utility companies would have had to reduce their rates by 15 percent each and every year. Suppliers of materials would have had to reduce their charges by 15 percent a year each year for the last 5 years, and then we would only be back

to the same competitive position that we were in 1980 in terms of what the impact of the dollar is in terms of those changes.

The elements that I would like to pick up a little bit from Dr. Hale's comments, is his discussion about the budget deficit and defense funding overseas. It seems to me that there are two ways in which that defense could have been funded. One is through the borrowing, which we currently do, to provide what he described as the short-term money coming in in Treasury bills. The other would have been to require particularly Japan to pay the same proportion of their GNP for defense as the United States does and to pay a larger share for the overall defense of the free world. We could do that directly in terms of maintaining funding for U.N. Forces and for U.S. Forces that are in the Far East, which play a major role, which they have not contributed to any major factor.

The United States spends approximately 8 percent of its GNP for defense, Japan less than 1 percent. That would be a major factor and another way of achieving that goal.

Mr. Hale spoke a little bit about the need for international surveillance and cooperation, and I agree that that is a major element in terms of trying to coordinate and to bring down the value of the dollar and to better interact with the fiscal and monetary policies of other countries.

But it seems to me those are long-term solutions. If we don't do something in the short term, we will have those trillion-dollar debts to foreigners that have been spoken about both by Mr. Hale and Mr. Bergsten in your former testimony. We shouldn't wait for a coordinated period of 4 to 5 years from now, to undertake a coordinated surcharge against those where there are current account surpluses, but that we instruct the President to apply the current provisions of the Trade Act of 1974, which allows the President to undertake either surcharges or to put into effect other quantitative restrictions on imports as a means to take care of fundamental international balance-of-payment problems.

If these are not times of international balance-of-payment problems, I don't know what greater evidence we need of such balance of payment problems, and we believe that it is important that if the President doesn't do that, that Congress do it directly in terms of putting into effect a type of surcharge to offset the impact that imbalance—that the overvalued dollar is having on our balance of trade.

Unless and until something like that is done, the gradualism Mr. Ortner talked about will lead to continued deterioration of our manufacturing sector, the continuing movement of firms abroad and the undercutting of U.S. manufacturing by imports and the continued deterioration not only in 1985, but in 1986 and 1987 and 1988 of the position of American industry as it exists today.

I do want to emphasize one other element Mr. Shumway raised. Not all trade problems are related to the overvalued dollar. It is a major factor, but it is not the sole and only factor that deals with the trade problem.

There are, of course, the restrictions that exist in a number of countries to the amount of U.S. exports to be brought into those countries on a free basis. There are a number of nonmarket economies that do not trade on a market basis. There are problems of

the failure to use the U.S. trade law in terms of providing temporary protection. And I think that is not an evil word, because the law provides for temporary protection to allow an industry to adjust to trade problems. That is what was envisioned when the law was passed so that industries and workers would not be suddenly thrown out of the workplace and out of an industry as a result of trade but would be allowed a temporary period to make changes and adjustments to try and correct those problems.

One of the major problems, though, that cannot be taken care of through those adjustment mechanisms is the overvalued dollar, and immediate action must be taken to try and offset that impact on industries, and if we talk of the gradualism of Mr. Ortner, the \$150 billion trade deficit with its impact on the balance of accounts in 1985, we will still be \$130 billion in 1986 and not much change in 1987, and I think that is the message that I would like to leave with you this morning.

Thank you, Mr. Chairman.

[The prepared statement of Rudy Oswald follows:]

Testimony of Rudy Oswald, Director, Department of Economic Research
American Federation of Labor and Congress of Industrial Organizations
on The U.S. Debt and the Dollar:
The Consequences for Growth and Structure of the U.S. Economy
Before the Subcommittee on Economic Stabilization
Committee on Banking, Finance, and Urban Affairs
U.S. House of Representatives

July 16, 1985

On behalf of the AFL-CIO, I wish to convey our thanks to you for holding this hearing; it is definitely needed.

Until a few months ago, the U.S. dollar seemed to defy the law of gravity. Since it took off in mid-1980, the dollar has been on a long-term upward spiral. The peak was reached in February 1985 when its value, compared with the value of currencies of 10 other major industrialized trading nations, had increased 87 percent from its mid-1980 level. That ratio is now down to about 70 percent. While there has been a measurable decline in the international exchange value of the dollar since mid-March, as U.S. interest rates declined, the dollar still is grossly overvalued against major foreign currencies and is still, at the end of June, 10 percent above the level of a year ago. The increasing value of the dollar contributed significantly to increases in the United States' merchandise trade deficit, along with export subsidies, tariff and non-tariff barriers to imports, dumping and other unfair trade practices. From a deficit level of about \$25 billion in 1980, it rose in succeeding years to \$28 billion, \$36 billion, \$69 billion, and \$123 billion in 1984 and is still rising. The very punishing growing merchandise trade deficit has impacted upon our economy and has cost the equivalent of 2 to 3 million jobs.

In its February 1985 statement on the Trade Deficit, the AFL-CIO Executive Council pointed out that \$89 billion of the \$123 billion overall trade deficit in 1984 was in manufactured goods and called for more effective relief to injured

TABLE I

BALANCE ON CURRENT ACCOUNT

UNITED STATES	(Value in billions of dollars)
1978	- 15.4
1979	- 0.9
1980	1.9
1981	6.3
1982	- 9.2
1983	- 41.6
1984	-101.6

Source: U.S. Department of Commerce, Bureau of Economic Analysis, 'Economic Indicators'

BALANCE OF MERCHANDISE TRADE
BASED ON F.O.B. EXPORTS AND C.I.F. IMPORTS

<u>UNITED STATES</u>	<u>(Value in billions of dollars)</u>
1970	- 0.2 estimated
1978	- 39.2
1979	- 42.4
1980	- 40.4
1981	- 36.4
1982	- 42.7
1983	- 69.4
1984	-123.3

TRADE BALANCE IN MANUFACTURED GOODS (C.I.F. AND F.A.S.)

<u>UNITED STATES</u>	<u>(Value in billions of dollars)</u>
1970	2.3
1977	- 1.8
1978	- 12.3
1979	- 2.1
1980	12.5
1981	5.3
1982	- 10.5
1983	- 38.2
1984	- 88.7

Source: U.S. Department of Commerce, International Trade Administration, 'International Economic Indicators'

industries and their workers. A copy of the Council statement is appended. The adverse effects of the trade crisis, which is dragging our economic growth to a halt is being felt in a great variety of production activities. That is borne out by the import penetration of U.S. markets. Thus, in 1984, the penetration ratios were 17 percent for computing equipment; 31 percent for metal cutting machine tools; 34 percent for semi-conductors; 48 percent for motorcycles, bicycles, and parts; 75 percent for fine earthenware; 78 percent for womens handbags, and purses; and significant ratios for many other product lines.

In the last few years, the United States has experienced both significant decreases in exports and increases in imports, adding up to many billions of dollars in agricultural products, forest products, textiles and apparel, footwear, chemical products, minerals and metals, and machinery and equipment.

The 1984 negative balance was accumulated through trade in various countries and regions of the world. The largest component of the negative trade balance was \$37 billion with Japan. Others were \$20 billion with Canada; \$17 billion with western Europe, including almost \$9 billion with Germany; \$11 billion with Taiwan; and \$8 billion with Mexico. The 1984 drop-off in American exports and increase of imports in such product lines was due in large measure to the overvalued dollar which during 1984 had an average exchange rate value that had risen 58 percent above the average value for 10 other major currencies since 1980. That means that American costs needed to be 58 percent lower in 1984 than in 1980 in order to be at the same competitive position that they held just four years earlier. Material, capital and labor costs would all need to be lowered by 58 percent to achieve in 1984 the same competitive position that American industry had in 1980. Thus, American workers would need to either be 58 percent more productive -- or take a 58 percent wage cut.

TABLE II

U.S. exports of domestic merchandise, imports for consumption, and merchandise trade balance, by major commodity sectors, 1981, 1982, 1983, and 1984

(In billions of dollars)

	1981	1982	1983	1984	Percent Change 1981-1984
U.S. exports of domestic merchandise:					
Agricultural, animal, and vegetable products (FAS)	43.7	37.1	36.5	37.6	-10.0
Forest products	9.2	8.5	8.5	8.6	-6.5
Textiles and apparel	8.2	6.5	5.7	6.4	-22.0
Footwear	0.1	0.2	0.2	0.2	100.0
Petroleum, natural gas, and related products	30.7	29.2	27.1	4.2	31.3
Chemicals and related products	20.0	14.8	13.7	30.0	-2.3
Minerals and metals	95.5	87.3	82.4	14.7	-26.9
Machinery and equipment	14.9	15.3	15.0	89.8	-6.0
Miscellaneous manufactures	20.3	19.0	20.5	15.2	2.0
U.S. imports for consumption:					
Agricultural, animal, and vegetable products	20.3	19.0	20.5	23.4	15.3
Forest products	9.6	9.0	10.8	13.2	37.5
Textiles and apparel	10.8	11.2	13.1	18.2	68.5
Footwear	3.1	3.6	4.2	5.2	67.7
Petroleum, natural gas, and related products	80.3	64.7	57.0	60.0	-25.3
Chemicals and related products	13.5	13.3	15.1	19.3	43.0
Minerals and metals	34.4	29.2	29.3	38.7	12.5
Machinery and equipment	68.5	72.4	85.0	117.2	71.1
Miscellaneous manufactures	13.3	14.1	15.7	20.9	57.1
U.S. merchandise trade balance:					
Agricultural, animal, and vegetable products	23.4	18.1	16.0	14.2	-39.3
Forest products	-0.4	-0.5	-2.5	-4.6	-1050.0
Textiles and apparel	-2.6	-4.7	-7.4	-11.8	-353.8
Footwear	-3.0	-3.4	-4.0	-5.1	-70.0
Petroleum, natural gas, and related products	-77.1	-59.0	-52.5	-55.8	27.6
Chemicals and related products	17.2	15.8	11.9	10.7	-37.8
Minerals and metals	-14.4	-14.5	-15.7	-24.0	-66.7
Machinery and equipment	27.0	14.9	-2.7	-27.4	-201.5
Miscellaneous manufactures	1.6	1.2	-0.7	-5.7	-456.3

To us in the labor movement, it is not right to expect workers to take a 58 percent wage cut to offset the effects of the fiscal and monetary policies pursued by the government. The tax cutbacks enacted in 1981, which benefitted primarily upper-income households and large corporations, contributed significantly to the annual federal mega-deficits which placed upward pressure on interest rates. At the same time, the Federal Reserve, pointing at the deficits and a possible return to high inflation, pursued a restrictive monetary policy. These were major elements in causing the rise in the dollar. The competitiveness of American workers is not impaired because their wages increased, but rather because the dollar rose in value. Workers are paying for this policy by losing their jobs to imports and being forced out of the export market. Later, I will discuss other factors, besides the overvalued dollar, that contributed to the negative trade balance.

In the last three years, the U.S. also began to run a deficit balance on its current account, as the net investment income received by U.S. residents declined, because there had been a large influx of foreign investments on which interest and dividends were paid. The net investment income received by U.S. residents became too small to outweigh the negative trade balance.

There were foreign capital investments in U.S. government and private securities, and in whole or share equity ownership of businesses. To make the dollar denominated investments, foreigners had to acquire dollars in exchange for foreign currencies, which kept the value of the dollar high. In fact, the dollar kept rising in value despite the large negative merchandise trade balance and the negative balance on current account. Instead of leading to a reduction in the value of the dollar, the trade deficits were offset by the capital inflows. The inflows also eased the financing of the federal budget deficits.

However, that temporary painkiller was aggravating the basic malady. As the U.S., in effect, kept borrowing through sale of securities and also sold physical assets to foreigners, it was creating a greater interest and dividend obligation for annual payments to foreigners. It would require greater borrowing in the future. In 1984, the U.S. net investment position was reduced by \$78 billion to a level of \$28 billion. During the second quarter of this year, the U.S. became a net borrower. This will be a factor toward enlarging the annual deficit on current account.

High interest rates were the great attraction for the foreign investments and thus contributed substantially to U.S. dollar overvaluation. The capital outflows from other major industrial countries slowed down their economic growth and demand for American products.

Back in 1980-81, most of the leading industrialized countries in the world shared with the United States the experience of very high interest rates in response to inflation and tight monetary policies designed to combat inflation. Japan, with the help of capital and credit market controls, was the first to bring interest rates down significantly, in the latter part of 1980. Germany brought its rates down in 1981. Both of the latter countries established interest rates well below those of the United States for comparable maturities. The United Kingdom and France took longer to bring their rates down, but in 1983-84 they also had interest rate levels below those of the United States. In Canada, the interest rate movements were fairly similar to those of the United States.

The U.S. dollar remained sufficiently "overvalued," so that many developed and developing countries could enjoy a significant price advantage over the U.S. and a favorable balance with the U.S. in international trade. Japan had the largest favorable trade balance with the United States -- \$37 billion -- in 1984 when the

exchange rate was 237 yen per dollar. In 1978, when the rate had been 208 yen and at times during the year at 180 yen to the dollar, Japan's favorable trade balance was \$11.5 billion. These results also reflect the effect of many Japanese trade barriers.

The relatively higher costs of new plant investments in the United States than in countries whose currency declined in value relative to the dollar also encouraged American firms to build new plants overseas, which meant that the jobs went overseas.

As the U.S. economy showed strong growth during 1983 and 1984, while a relatively tight money policy was pursued, interest rates in this country remained high; and the foreign capital inflow continued. If there was evidence needed that the interest rates were a strategic factor in maintaining the high value of the dollar, it was provided by the economic record of the first quarter of 1985. With the slowdown in the economy to a much slower growth rate, interest rates dropped; and the Federal Reserve Board let nature take its course in a softening economic climate. The exchange rate value of the dollar also declined. Against the German mark, for example, the dollar has declined by about 15 percent since mid-March. However, that still leaves the exchange rate value of the dollar more than 60 percent higher in terms of the mark than it was in 1980.

As a consequence of high U.S. interest rates, developing countries have suffered by having to pay high interest rates on their loans. On the other hand, the resultant high value of the dollar has helped them, as well as major industrial trading partners of the U.S., to sell their exports in the U.S. and elsewhere in competition with U.S. producers. The massive, growing U.S. negative trade balance, contributes significantly to an economic slowdown and contraction of the largest market for products from other countries. The whole quagmire of

misaligned exchange rates and abnormal trade imbalance cries out for an international solution. It highlights the contrast between the significant progress in development of an international economy and the lack of adequate international institutions to address the intertwined exchange rate and trade problems. The U.S. economy is an integral part of the more internationalized world economy. Twenty and twenty-five years ago, the value of U.S. exports equalled 4 percent and of imports 3 percent of GNP. In 1984, the exports equalled 6 percent and the imports 9 percent of GNP. Thus, as a measure of internationalization, our total trade value grew from 7 to 15 percent of the GNP. Also significant is the fact that instead of a 4:3 ratio of a couple of decades ago, the U.S. now has a 2:3 ratio of exports to imports.

While the International Monetary Fund is charged with promotion of exchange stability, and exercises "firm surveillance" over the exchange rate policies of its members, it does not provide a forum for negotiations to arrive at an exchange rate alignment that will promote greater balance for international trade and economic growth. In the absence of institutional innovations to address the international exchange problem, the central bank of each country will continue to devote its paramount concern to domestic economic problems. It will be difficult to achieve a coordination of national monetary policies which is needed to obtain a reasonable equilibrium of exchange rates. To effectively achieve the stated objective, it would require the establishment of an international forum, at least among a few major industrial nations, for continuing negotiation to make adjustments from time to time that would produce an equilibrium of international exchange rates to avoid such a misalignment and huge trade deficits as the United States is presently experiencing.

The American economy, and eventually the world economy, cannot continue on a path of stable economic growth with such a trade deficit for the largest economy. Furthermore, experience of the last few years would indicate that the trade deficits, in themselves, will not in this age soon bring about a realignment of exchange rates. Individuals and businesses around the world can take advantage of modern communications for conversion of money from one currency to another and electronic transfers to invest funds in those countries where high yields are available. While such capital inflows to the U.S. have helped to finance the federal budget and international trade deficit, the dollar has remained overvalued, a significant factor in the continued growth of the U.S. trade deficit. The necessary international consultations and negotiations for dealing with periodic realignment of exchange rates might be undertaken under expanded auspices of the IMF, the OECD, or in a special forum created for the purpose.

Such a forum could have several tasks. One would be to prepare for fire fighting actions against speculative attacks on currencies that cause great volatility. An anti-speculation intelligence apparatus and firm commitments for necessary large-scale intervention should be established.

A more important function would be to have under continuous review the interest rates, international capital flows, and exchange rates and their effects upon the national and international economies. Much of the economic data and analytic work produced by the OECD and IMF would be helpful. The objective would be to provide a basis for negotiations for changes to produce greater stability in exchange rates and reasonable international trade balances. There might be some helpful trade-offs negotiated. For example, there might be an agreement for changes in monetary policy to lower interest rates in country A by 2 percentage points if country B would lower its rates by 1 percentage point, looking

toward a change in economic growth rates, capital flows, and exchange rates that would reduce a large trade imbalance.

The AFL-CIO, among others, has been recommending the creation of such a facility at Congressional hearings and before various forums. In response to growing recognition of the need for a facility along these lines, the "Group of Ten" industrial nations, of which the U.S. is a member, has proposed that the IMF be empowered to exercise closer "surveillance" of the economic policies of the 10 industrial nations to promote greater stability in currency relationships. As part of this expanded surveillance, reportedly, the finance ministers and central bank heads of the countries would join in "multilateral surveillance" of each others' economic policies by reviewing, in advance of publication, a report by the IMF assessing each country's economic performance.

The aforementioned proposal would create a necessary forum, but a more broadly defined objective is needed; namely, to arrive at realignments of exchange rates that would help to bring about a less imbalanced international trade equilibrium. The basic international cooperative efforts, and negotiations, would involve the finance ministers and heads of central banks, to work at coordinated trade-offs with respect to domestic monetary policies and their effects upon capital flows for investment and exchange rates. However, since trade relations will be affected, trade ministers should also be involved; and the impacts upon trade should be recognized and considered, with a view toward achieving improved trade balance in the international economy.

The aforementioned undertakings probably would require many months to come to fruition. In order to get some quicker results, although in a more limited scope, another subject for study and negotiation, that might be tackled first, would be the matter of possible modifications of the present exchange rate system, which

is coordinated within the European community, but not for the rest of the world. There have been suggestions that if deliberate coordination might be undertaken by three leading countries -- the United States, Japan, and Germany --there could be greater stability in the entire international exchange rate system.

Even that study with a shorter time frame probably would not lead soon enough to amelioration of the trade problem facing the United States, which is serious and immediate. The President should take action to remedy the situation under an existing statute.

The President is directed under Section 122 of the Trade Act of 1974 to take certain actions "whenever fundamental international payments problems require special import measures to restrict imports." These actions are to be taken to deal with large U.S. balance of payments deficits, to prevent an imminent and significant depreciation of the dollar, or to collaborate with other countries in correcting an international balance of payment disequilibrium. The President, under such conditions, may, for a period of up to 150 days, impose a temporary surcharge of up to 15 percent on imported articles, invoke temporary limitations through quotas on imports of articles, or do both. Such temporary actions could and should be used to help alleviate the present trade imbalance. However, the President has not taken any action. The Congress should act to advise the President that, in light of a negative payments balance of over \$100 billion last year, reflecting a large and growing trade imbalance, the conditions that require Presidential action under Section 122 of the Trade Act of 1974 now exist; he has not advised the Congress, as required, that the imposition of import restrictions under Section 122(a) would be contrary to the national interest; and he is directed to impose such restrictions.

As has recently been suggested by some European officials, there is a need for international discussions on monetary policy to go on in parallel with and be coordinated with discussions for modified trade agreements. Since the two types of policies necessarily have interacting effects, it is essential that the negotiations on the two policy matters be coordinated. There have been objections to this idea from officials who deal with trade and from some concerned with general economic policies. Their life would become more complicated, but this is a necessity in an international economy that has become more complicated.

If the foregoing exchange rate policy remedies are adopted and implemented, more stable exchange rates and increased international trade would be encouraged. This will not happen overnight, however, and a large dollar overvaluation will continue to give foreign producers competitive price advantages ranging between 15 and 50 percent. There are also other factors, stemming from the fact that the United States adheres more to free trade than its trading partners. Most obvious is the growing volume of imports from non-market economies which are the antithesis of free labor and cannot be included as part of a free trade world economy in an accepted meaning of the words. There are many other countries where there are no restrictions against child labor and a lack of regulation to protect the health and safety of workers.

Some of the advanced industrial countries have given producers of export products below-market interest rate financing and have kept foreign competition out of their domestic markets through tariff barriers, restrictive product specifications, inspection slowdowns, and other non-tariff barriers.

With respect to less developed industrializing countries, however, the serious competitive pricing gap, as compared with the U.S. and other advanced industrial countries, will not be closed because of a huge wage gap. In some developing countries wages amount to only a minor fraction of wages paid for comparable work in the United States.

Price competition by U.S. producers to overcome all of the aforementioned unfair trade practices and low labor standards would require such low wages in the United States as to cause a significant reduction in the standard of living and a contraction of the U.S. economy. Letting the low wage and subsidized products of many developing countries into the United States without any restriction would mean increased unemployment. There has been, over about the last 15 years, an upward, long-term trend in the U.S. unemployment rate. That unemployment rate, moving in a pattern generally inverse to the business cycle, has been rising from one peak to the next and from one trough to the next. The resulting long and deep recessions cause a considerable slowdown of economic growth when they occur and also for the future as lost product income, savings, and capital formation retard the economy.

Incidentally, U.S. consumers get a relatively small part of the wage differential advantage, as the foreign producers, exporters, importers, and retailers each take as much advantage to increase their mark-up as the market will permit.

U.S. trade law must be strengthened to reflect international trading realities. It is time to recognize that the principal approach to trade problems taken by the U.S. government -- encouraging other countries to stop what are considered to be objectionable practices -- has failed. Both "fair" trade laws designed to alleviate trade-induced injury and "unfair" trade laws designed to counteract dumping and subsidies should have better procedures and more effective remedies.

The AFL-CIO believes that the help promised to injured industries for 20 years had not become a reality. The safety valve promised to those who are affected by tariff-cutting and import surges, the so-called "escape clause," now Section 201 of the Trade Act of 1974, has never been effective. The escape clause provisions of the Trade Act should be revised to allow quick relief from trade injury.

The 1981-82 worldwide recession experience illustrated the effect of an U.S. economic contraction on other developed and less developed countries. Against this background, the U.S. labor movement has advocated import quotas for various products which would permit a margin of growth for LDCs without overwhelming the U.S. economy. The advocates of pure free trade claim that workers who become unemployed because of imports should go elsewhere to seek work. The thesis has been developed that growth requires both labor and capital resources to be continually reallocated to their most efficient uses. This is even used as a rationale for curtailing unemployment compensation, to remove disincentives for people to move out of declining industries and areas into growing ones. In a more formal statement of the thesis, it has been said that benefits for the unemployed and unions do not allow labor "to clear the market." In other words, labor should be treated as a commodity. That notion was outlawed in the United States in 1914 when the Clayton Anti-Trust Act was enacted with the declaration that "labor is not a commodity," exempting unions from legal characterization as a trust. The growth of unions in the U.S. during most of the intervening 70 years helped provide an income distribution to foster a balanced economy that grew over the long run.

The international economy does not have an income distribution that fosters balanced economic growth, even to the less than satisfactory degree that is currently found in the United States. Until such time as the wage gap can be narrowed to greatly reduce the competitive price advantage, there should be fair trade import quotas for developing nations to permit them limited shares in the U.S. market for various products without overwhelming the U.S. productive economy and contracting that market to the detriment of all concerned.

Attachment

Chairman LAFALCE. Thank you very much, Dr. Oswald. In your written testimony, you made reference to section 122 of the Trade Act of 1974, empowering the President to take remedial actions whenever fundamental international payment problems mandate. Has any President acted under section 122? Do you know? We have only had it since 1974.

Mr. OSWALD. There was a temporary surcharge put into effect by Mr. Nixon in 1971, at the time of his August 1971 economic change where he put into effect the beginnings of the separation of the dollar from gold and the beginning of the floating of the exchange rates which moved forward—

Chairman LAFALCE. Was this some predecessor provision of section 122 which empowered him to do that?

Mr. OSWALD. There were provisions which empowered him to do that. I think he did it under the emergency powers under the Defense Production Act, if I recall correctly.

Prior to 1974, there were fairly broad powers of the President under the Defense Production Act, but I am not positive of the exact provisions under which that action was taken.

Chairman LAFALCE. I was just curious about that.

Mr. OSWALD. But I think that if Congress meant anything in 1974, the current vast gyrations and their impact on international payments clearly meet the sort of situation envisaged.

Chairman LAFALCE. If they, in fact, meant anything.

Mr. OSWALD. If they meant anything.

Chairman LAFALCE. You called in your testimony for simultaneous and coordinated international monetary consultations, discussions and agreements along with trade. Is this a formalized position of the AFL-CIO?

Mr. OSWALD. Yes, Mr. Chairman. I am sorry that I only appended to my testimony the February AFL-CIO executive council statement on the trade deficit; at its May executive council meeting it did take a formal policy position that essentially said what you have just said, and I would be happy to forward it to the committee and ask it be made part of the record.

Chairman LAFALCE. Please do so.

[The AFL-CIO executive council statements referred to follow:]

Statement by the AFL-CIO Executive Council

on

The Trade Deficit

February 19, 1985

Bal Harbour, FL

America's trade problems have reached crisis proportions. The decline of the U.S. international economic position has caused untold hardship for millions of American workers and scores of communities, and threatens the economic health and security of our nation. Unfortunately, the Administration clings to a belief in mythical market forces and in an illusory free-trade theory at a time when positive action is desperately needed to reverse the erosion of America's industrial base.

The legal framework governing America's international trade was designed in an era when total trade was less than 4 percent of the gross national product, when little more than raw materials were imported from developing countries, and when tariffs were the main form of government action affecting the flow of goods in international commerce. Today the picture has radically changed. After two decades of meteoric growth, imports of manufactured goods account for more than one-fourth of overall U.S. industrial consumption, virtually all manufacturing output competes with foreign-made products, and vital sectors of our economic base have been decimated by import competition. In the 1980's, the newly industrialized low-wage countries of East Asia and Latin America have become "new Japans," challenging American producers abroad and in our own backyard, while new potential competitors with still lower wages are seeking to follow in their path.

The failure of America's traditional approach to the basic issues of industrial and trade policy is starkly highlighted in the trail of red ink that records America's worsening trade deficit. Our country did not have a trade deficit in this century until 1971. By the later 1970s, that deficit had grown to \$40 billion annually. In 1980, the U.S. trade deficit

reached \$123 billion overall, with an \$89 billion deficit directly in manufactured goods. Some are predicting that the trade deficit could rise to \$250 billion by the end of the 1980s. These mind-numbing dollar losses have already resulted in the loss of over 3 million jobs, primarily in manufacturing industries, and have caused serious damage to America's industrial base, with prospects of more to come unless effective counteraction is taken soon.

This trade crisis is now striking at every point on the industrial spectrum, from labor-intensive to capital-intensive industries, high tech and low tech, from the oldest to the newest industries. No sector is immune.

Complete solutions to these problems will require effective national industrial and economic policies, including specific sectoral policies, better fiscal policies and lower interest and dollar exchange rates. Over the last 4½ years, the value of the dollar has risen some 70 percent against the currencies of U.S. major trading partners, raising the price of exports and lowering the cost of imports. The absence of effective remedies to address domestic injury caused by imports has worsened the impact of the vastly overvalued dollar.

U.S. trade law and policy must be brought into line with today's trade realities. The academic abstractions of free trade and natural comparative advantage, if they ever had any relevance, are inadequate guides for the real world of international commerce in the 1980s. U.S. trade law must be modernized to reflect contemporary realities in a world where the U.S. is the only country which exposes its industrial foundation to unlimited erosion from imports.

We emphasize that conserving American jobs and conserving American industries are political decisions for which members of Congress must be accountable, and the Administration must be held fully responsible.

The overhaul of U.S. trade law needed to remedy general shortcomings must include:

- Injury from unfair trade practices such as dumping, subsidies, and disruptive imports from nonmarket economies must be fully remedied by U.S. law. At present, too many of the injurious practices developed in recent years escape U.S. law against unfair trade practices, and other countries can increase their unfair sales in this country without fear of penalties.
- Export-oriented industrial targeting is practiced by foreign governments that seek to expand their sales and employment at the expense of the United States or other countries. Machine tools, autos and auto parts, refined petroleum products and chemicals, and electronics are some American industries that have been injured by these export-oriented targeting strategies. U.S. laws designed long before these practices developed should be revised to provide effective relief.
- Providing relief to U.S. industries injured by imports is a right recognized under international law, but the U.S. standards for qualifying for such relief are stiffer than international rules require. The U.S. standard for import relief in the "escape clause" (Section 201 of the Trade Act) should be eased, specifically recognizing plant closings and layoffs as signs of serious injury in qualifying for relief.

Beyond general reform of existing trade law, many specific trade-related problems remain to be solved. The difficulties encountered by individual industries require remedies tailored to their own special circumstances:

- Domestic content laws continue to be necessary to help assure that the U.S. remains a producer of autos. Priority should be given to a multi-year

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extension and revision of the Voluntary Restraint Agreement with Japan

-- based on a percentage of U.S. sales rather than on a fixed number.

- The President's national policy for import restraints on steel must be fully implemented and the Steel Import Stabilization Act must be vigorously enforced, particularly with respect to modernization and the training of displaced workers. Should the import restraint program prove ineffective, quota legislation will be necessary.
- The President must immediately implement the Congressional direction to negotiate voluntary production restraints on copper. If Congressional intent is ignored, legislation will be necessary to maintain a vigorous domestic industry.
- To revive the U.S. maritime industry, legislation is needed to substantially increase the portion of cargo carried in U.S. flagships and to assure a strong U.S. shipbuilding base thereby enhancing national security. Further, immediate action is necessary to eliminate foreign barriers to U.S. transport carriers involved in international commerce.
- The prohibition on Alaskan oil exports should be maintained, and carriage of the oil retained for U.S.-flag vessels.
- Despite the theoretical safeguards contained in the Multi-Fibre Arrangement (MFA), imports of textiles and apparel have continued to increase dramatically in the last two years. The Textile and Apparel Recovery Act of 1985 is needed to make the promise of MFA a reality and to roll back imports to a reasonable and stable level.
- Following the International Trade Commission (ITC) denial of import relief for the shoe industry, imports of footwear have captured 73 percent of the domestic market. Under mandate of Congress, the ITC has

reopened the case. If the industry is to survive, relief must be recommended by the ITC or further Congressional action will be required.

- Since the AT&T divestiture, imports of telecommunications products have inundated the American market, while foreign markets remain closed to American goods. Legislation is needed to correct this inequity and reduce the level of imported products.
- Policies should be pursued to maintain and re-establish domestic electronic and television industries.
- The manufacturing clause of the Copyright Law must be extended permanently in order to protect against widespread loss of jobs throughout the U.S. printing industry. The U.S. can ill afford another unilateral giveaway of U.S. production.
- The AFL-CIO reiterates its opposition to semi-conductor tariff cuts and the establishment of bilateral free-trade areas.
- Policies should be enacted to assure that a significant portion of U.S. raw materials destined for export, such as grains and logs, are processed in this country.

In addition to the individual industry requirements, other trade-related measures are necessary:

- The Trade Adjustment Assistance program which is due to expire in September 1985 must be renewed and funding restored in order to assist those workers displaced by imports.
- Export promotion should continue as an important function of trade policy. Export-Import Bank funding, including direct loan authority must be maintained in order to provide U.S. industry with tools necessary for international competition. These funds should be made available for the domestic purchase of U.S. products

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to offset foreign subsidies. Financing, however, should not be used to develop projects in other countries in industrial sectors where excess capacity exists.

- While exports are important for domestic economic growth, the transfer of U.S. technology must be controlled to assure continued technological advances, national security and competitive advantage for domestic production.
- In addition, Congress must enact restrictions on U.S. trade and investment with South Africa as an important means of pressuring that country to end its policy of apartheid.
- Policies must be enacted to regulate the immense flows of international investment. Existing codes of conduct for multinational enterprises must be better enforced to protect the rights of workers employed by these firms and to provide effective remedies when those rights are denied.
- Current Administration emphasis on overseas investment by American firms must be redirected. Authority establishing the Overseas Private Investment Corporation should be allowed to expire this year. Emphasis should be placed on furthering the interests of the U.S. economy and U.S. workers, not multinational enterprises.

If a new round of trade negotiations develops, as the President has suggested, priority should be given to correcting problems that remain from the impact of the 1979 multinational trade negotiations. The results promised in 1979 have not been achieved, and steps should be taken to reassert U.S. interests. In addition, before the United States begins multilateral trade negotiations on trade in services, a clear definition of services and adequate information must be developed. This information must include reliable statistics and an assessment of the employment effects of trade in services.

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The United States must not negotiate away domestic employment for business access to foreign markets. Meanwhile, negotiations on services trade should be conducted bilaterally on a case-by-case basis. Where unfair foreign barriers against U.S. services have negative effects on U.S. employment, the government should promote the interests of domestic service industries. U.S. law and practice establishing standards in the service sector must not be weakened.

While disappointed with the extension of the Generalized System of Preferences (GSP), the AFL-CIO applauds the addition of strong labor rights provisions in that program and will work to ensure their effective implementation.

America needs to explore a more realistic general framework for coordinating world trade relationships in sectors characterized by global overcapacity and widespread import controls. The United States operates as if the trade-regulating measures of other countries did not exist -- or as if they were irrelevant in determining whether trade is likely to injure U.S. workers and industries.

The temporary and often ineffective U.S. regulation of imports in many sectors has not accomplished its purpose; other countries have dealt more effectively with international trade to promote industrial development -- and employment. At least when there is widespread import injury, and when trade problems have led the major importing countries to apply import restraint, then the U.S. should negotiate an effective multilateral framework for allowing sectoral trade to take place in a rational manner, the same time preserving our vital economic industrial base and jobs.

Fact Sheets

TRADE
FACT SHEET

U.S. BALANCE OF TRADE
(Billions of Dollars)

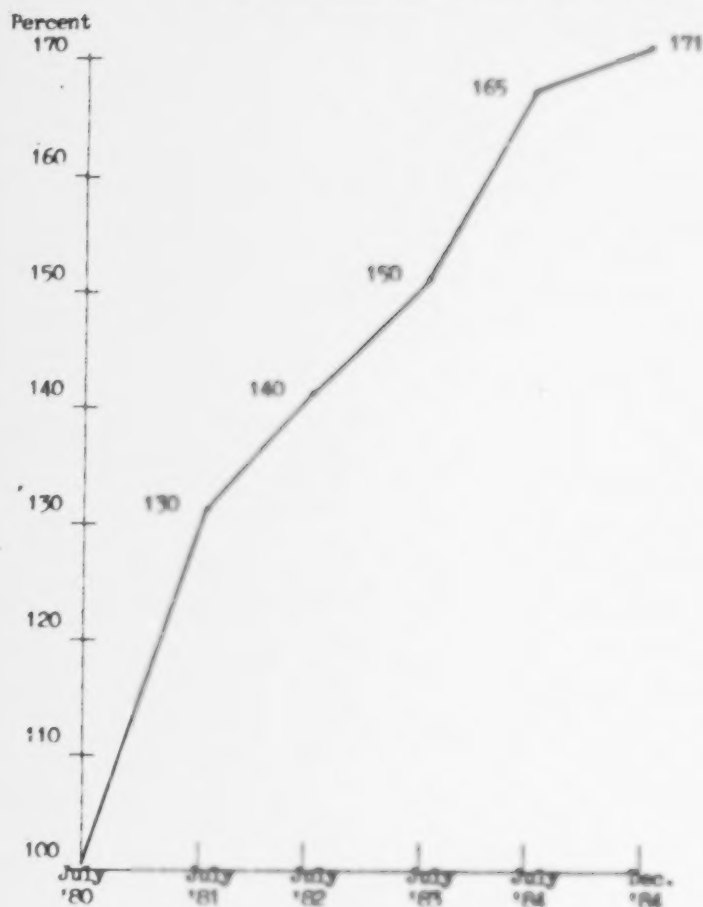
	<u>Merchandise Trade Balance</u>	<u>Manufactured Goods Trade Balance</u>
1970	- 0	2
1978	- 39	- 12
1979	- 42	- 2
1980	- 40	13
1981	- 36	5
1982	- 43	- 11
1983	- 69	- 38
1984	- 123	- 89

BILATERAL U.S. MERCHANDISE TRADE BALANCE - 1984
(Billions of Dollars)

Canada	\$ - 21
European Economic Community	- 13
Japan	- 37
Mexico	- 6
Taiwan	- 11
Republic of Korea	- 4

February 1985

Rise in Value of the U.S. Dollar - July 1980 * to December 1984
Trade Weighted Average of Major Trading Partners



	Currency Units per U.S. Dollar		% Change Since July 1980 *
	Dec. 1984	July 1980	
German Mark	3.11	1.75	77
French Franc	9.51	4.06	126
Canadian Dollar	1.32	1.15	14
British Pound	0.84	0.42	91
Japanese Yen	248	221	10
Italian Lira	1,913	852	124

* Date of the lowest weighted-average exchange value of the dollar since exchange rates were allowed to float.

February 1985

Statement by the AFL-CIO Executive Council

on

TradeMay 8, 1985
Washington, D.C.

The trade deficit which ballooned to \$123 billion last year has risen by 9 percent in the first quarter of 1985. The deficit for manufactured goods has increased even faster and is projected to exceed \$100 billion by the end of the year. Despite recent fluctuations, the dollar in March was 87 percent higher than in July 1980 against the currencies of major U.S. trading partners. The dollar appreciation has had disastrous results on imports and exports and spurred new plans for U.S. firms to relocate overseas.

In light of the record high trade deficits and the soaring dollar, the Administration's proposal for a new round of multilateral trade negotiations should not be allowed to take the place of needed efforts to deal with specific domestic trade problems and should not substitute for specific action correcting the imbalance in exchange rates. The AFL-CIO spelled out at its February Executive Council meeting a series of domestic administrative and congressional actions to deal with specific trade problems confronting the United States. These actions would improve the handling of domestic injury, unfair trade practices and adjustment for workers and communities, and provide a remedy for specific industry problems.

In terms of the overvalued dollar, there must be a major effort to readjust currency values to more realistic levels and to bring some measure of stability to the exchange rate system. While national action in the form of an import surcharge would provide some immediate relief from the trade-distorting impact of the overvalued dollar, we believe that a longer-term solution must be found through coordinated international actions. The United States should undertake monetary negotiations in a variety of forums such as the International Monetary Fund (IMF), Organization for Economic Cooperation

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and Development (OECD), and Generalized Agreement on Tariffs and Trade (GATT). Such negotiations should be a precondition of any multilateral trade talks.

The AFL-CIO shares the reservations of many at home and abroad about the appropriateness of multilateral trade negotiations. Nevertheless, if negotiations take place, the U.S. should focus on the following four areas:

- A principal U.S. trade negotiating objective must be to include in GATT a social clause that addresses unfair trade advantages gained through repressive working conditions. Competitive advantage in trade should not be derived from the denial of the right to freedom of association or the refusal to insure a safe work environment, the exploitation of child labor or other unacceptable practices. The U.S. has already taken steps in this direction by insisting on the inclusion of labor rights and standards criteria in the law on Generalized System of Preferences.
- The impact of the various codes agreed to in the 1979 MTN needs to be assessed and greater attention should be placed on enforcing these agreements and redressing inequities that have appeared. The Government Procurement Code should be renegotiated to provide true reciprocal market access. Examination of preliminary data makes it clear that U.S. expectations have not been fulfilled. Changes in domestic regulations (AT&T divestiture) have served only to sharpen the inequities.
- The inadequacies of GATT safeguard procedures need to be addressed. We strongly believe that the U.S. should concentrate on exposing trade restrictive measures and should develop procedures for negotiating agreements that would bring some order and stability to trade in import-sensitive products, as well as products and commodities where worldwide excess capacity exists.
- Solutions to the serious problems faced by U.S. industry in the area of counterfeiting and intellectual property rights, such as computer programs, films and recordings, should be a major U.S. objective.

Trade

With regard to problems in services, solutions must be found through national action and sectoral negotiations. The current emphasis on all-inclusive negotiations on trade in services is misplaced. The trade problems encountered by U.S. service industries are specific and quite diverse. The problems of construction and engineering are not the same as the problems of entertainment; the problems of banking and insurance have little in common with difficulties in transportation. These differences make it essential that negotiations be based on practical solutions for specific current problems so that the huge diversified service industry will not be lumped together inappropriately in multilateral negotiations.

What may appear to some as trade "distortions" in the service sector are in fact proper and even essential social and economic policies in both the U.S. and foreign economies. Banking and insurance regulations, protections of personal privacy, and standards for lawyers, doctors, accountants, and immigration rules are but a few examples.

Instead of broad negotiations on investment rights, emphasis should be placed on encouraging domestic investment. As with trade in services, regulations concerning investment flows should not necessarily be viewed as barriers. However, the U.S. must address those policies and take action when they injure U.S. production and employment.

Given the severity of our national economic problems and the continuing erosion of domestic manufacturing industries, U.S. trade and procurement policy must be designed to promote the growth of U.S. employment, higher levels of real income, and a diversified industrial economy. Such trade policy needs to include policies to deal with the over-valued dollar as well as specific sectoral problems.



Chairman LAFALCE. I will defer to the other members of the panel for questioning first. Mr. Torres.

Mr. TORRES. No questions at this time, Mr. Chairman.

Chairman LAFALCE. Mr. Grotberg.

Mr. GROTBORG. I missed the testimony, I am sorry. My concern is wage differentiations internationally and how they can be equalized. Mr. Chairman, I liked the phrase you picked out—where there is such a big gap. Is that one of the gnawing problems for the AFL-CIO? It wasn't the thrust of your testimony, but it is one of the root problems, isn't it?

Mr. OSWALD. There are——

Mr. GROTBORG. Without disadvantaging American workers too much more, we have to do something about the other workers overseas.

Mr. OSWALD. There are two problems. One I alluded to in my comments. I think it is very important because I think it is a central issue. Particularly against those countries where the dollar has increased in value, it varied substantially, and it has increased 70 percent, almost 15 percent a year for each of the last 5 years, and even where there is some decrease, it is still 10 percent above 1 year ago. It means workers would have had to take a 10-percent wage cut every year for the last 5 years just to be back where they were 5 years ago, not just workers, raw materials prices would have to go down, utility prices, everything else, because that is essentially the effect of the overvalued dollar.

What it does do is make imports that much cheaper and in order to export it makes those things that much more expensive. And to expect workers to offset that sort of change I think is just unreasonable. People just couldn't afford to maintain their homes any more or anything else if they took that 15 percent wage cut.

But there is a second group of countries where the exchange value hasn't changed very much. Korea, for example, has somewhat tied their exchange value to the United States. But they have kept wages very low, they have kept their exchange value very low related to the U.S. dollar. They continue to employ children for a vast variety of production of goods. They really do not allow free trade unions and free collective bargaining in what are called export industries so that the workers are not participating in any of the advances that are being made in general on the export side in Korea.

Until some of those things are changed, we should not allow those goods to come into this country to undercut our operations.

Mr. GROTBORG. May I continue, Mr. Chairman?

Chairman LAFALCE. Sure.

Mr. GROTBORG. Do you think you and I are going to live long enough to run North Korea?

Mr. OSWALD. Some of this is true in South Korea as well.

Mr. GROTBORG. North Korea is even worse.

Mr. OSWALD. I don't understand why we trade with what I call nonmarket countries, Communist countries, as if they were free market operations.

Mr. GROTBORG. What I don't understand is how we can really run the whole world from Capitol Hill. I think if—we need a long-range solution as we have all said. The only long-range solutions I

can really look at, or probably anybody at this table, is to do something about how the United States of America approaches this subject as a nation, first of all, and then, second, on the international scale, as you said—Mr. Hale knows we have to do it—if we are going to get at the nub of the problem in our lifetime, we better be figuring out an American way of doing business to handle that and things we can control.

You can't control the economy of Angola, Zimbabwe or whatever country it is. It seems like we just are so busy in this exercise of trying to run every government in the world while our own is going down the chute on this issue. We are still the greatest country in the world or that money wouldn't be coming over here.

I am looking for you to at least nod your head that we've got an American problem built into this as well as an international problem.

Mr. OSWALD. We would agree there is a serious U.S. problem and that the United States needs to act to assure that this economy remains a diversified economy and one that is able to produce the goods and services that it basically needs without the large dependence upon foreign producers. We can't continue to borrow forever from abroad without at some point having to pay it back.

Mr. GROTEBERG. What if we selectively took any country that has a huge wage differentiation, and found an organized way to import their merchandise or services to this country, particularly manufactured merchandise, on a percentage of the market rather than a selected tariff—not unlike the automobile. For instance, 25 percent of a product could be imported, and at the point it arrives here, the wage differentiation is equaled and it becomes the cost of the merchandise. I am not an economist. But the American worker is the one that is suffering more than anyone.

The national economy can take all this flexibility in the free economic system, but those that get hurt belong to each of us at this table and probably some of them are your members.

Mr. OSWALD. That is right.

Mr. GROTEBERG. It has been a nice morning to spend with both of you. Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Vento.

Mr. VENTO. Thank you.

Mr. Hale, I paid close attention to your statement, at least in reading it as close as I could given the few minutes I had to review it, and I found it very interesting. The point I think that you point out is that the United States is a net debtor of credit, and you focused on what utilization of credit is, and you qualified that as saying is it importable or tradeable versus nontradeable types of goods, and you point out going into service and construction, which are really basically domestically consumed.

In other words, if I understand that right, doesn't it make us better prepared for the 1990's in terms of being able to penetrate other markets with our products? Is that the essence of what you are saying?

Mr. HALE. Yes; there is some unrecorded income that will help make our balance of payments better. Taking the decade as a whole ahead of us, I believe there will be a significant further deterioration in our trade position because of the mix of investment we

are getting right now from the interaction of our policy and policies of other countries. Whenever you have a country with an overvalued exchange rate, you typically over time get a concentration of investment in real estate and services and the manufacturing sectors not affected by foreign competition.

That happened in Latin America in the late 1970's and has been happening here with increasing frequency in the last 9 months.

Mr. VENTO. As I look at the appendix, at least the first sheet, I think it is worth our further examination more closely for all of us—it points out the general Government financial balance, and we look at Japan and Germany during the 1970-80 sequence, and we find they are minus 4, 3.9 and so on and so forth and now they are trailing off. That indicates, of course, the focus there on the use of that credit is much different.

I think what you are saying is that that investment actually is going into tradeable sources, that is, manufacturing.

Mr. HALE. This year capital spending will rise at double-digit rates in response to the dollar and exports to other countries, that is correct.

Mr. VENTO. And it is in segments of the economy that are what, really going into tradeable items?

Mr. HALE. That is correct. This will increase manufactured goods.

Mr. VENTO. That is something we have to pay close attention to in terms of how we utilize this credit. I always remember in my history the fact we are very successful in getting Britain to invest in canals in this country, most of which have very little utilization. But, nevertheless, it was a positive stimulus in terms of the economies of Ohio and other States.

Mr. HALE. Much more of the investment in the 19th century was in equity form. The fact investment didn't work, they lost, we didn't. A lot of the capital costs are coming in the form of debt instruments, be it Treasury bills, CD's, or other kinds. And, consequently, if the investment doesn't pay off, we have to pay the bill. It is important to distinguish between equity and debt. If you look at examples of other countries like Australia, you will see often their balance of payment meets a crisis when they borrow too heavily as opposed to getting equity investment.

Mr. VENTO. Let me ask you. First, we also note somewhat of a decline in terms of the dollar value in the last 4 months, and I guess that gives us breathing room, plus, of course, the monetary policy that is now being pursued. Of course, no one wants to take any credit for having any impact on interest rates. That is one of the phenomenon I find most interesting in Washington.

It sort of happens through the magic of the market, or something like that. They are all very evasive about taking any credit for it. But I suspect that some of these factors do influence it. Nevertheless, in looking at that drop or decline in dollar value, one of the first things we go to is what is the impact on imports? You point out the first wave of that is going to mean the continued purchase of foreign goods will not be curtailed, that it will in fact compound the deficit because these items we are purchasing, automobiles, whatever else, I guess, will in fact be more costly to purchase and they will continue, so that you expect the trade deficit, if that phe-

nomenon were to continue, to actually increase; in other words, that compounds it on top of the other problems. Is that accurate?

Mr. HALE. Yes; the short-term is called the J-curve effect; the price of imports goes up and, therefore, our overall bill goes up. Over time, the higher price should discourage consumption and cause reallocation of market share in favor of domestic producers at the price of domestic inflation.

Mr. VENTO. I think probably there is a lag in terms of it, when we enter into it, it isn't automatic. But if, in fact, they are a product, if someone wants a Japanese automobile or a sports car or some other particular product, that would also influence it, would it not?

Mr. HALE. Absolutely; there are tradeoffs in terms of price and uniqueness of the product. I would say that every product has some characteristics, but there has been in the last 2 years, because of the overvalued dollar, significant rise in what I would call commodity type articles. There I would look for an improvement in our trading account within a year.

Mr. VENTO. If domestically we could produce that product any longer. That doesn't address the fact we may have lost some of the capacity to do that. That would also be accurate.

Mr. HALE. That is my concern. I believe the change in investment mix would point to that kind of problem over time, a decrease in the capacity to produce. If you had manufacturing people here today, you could ask them about their foreign source, and they might tell you in many cases whereas 5 years ago they foreign-sourced 10 to 15 percent, today it is more like 35 or 40. It will take time to unwind that relationship.

Mr. VENTO. How would you describe the disparity, the 81-percent plant utilization rate today at the height of our recovery? How would you interpret it? You are saying that that plant capacity is not necessarily a match for what might be the needs of the demands?

In other words, there is not a perfect match? Do you have any advice in terms of that plant capacity?

Mr. HALE. I think plant capacity is one of the most illusive things we try to measure. I don't think researchers came up with the change in the structure of the economy. The answer is I believe we have a potential problem, but I cannot say just how great it is. I know from talking to manufacturing companies, they will resource in the United States in 2 or 3 years' time if the dollar does fall very sharply, but it will take a couple of years to retool and reequip themselves to depend on American suppliers.

In the meantime, American suppliers have gone out of business or have cut back their capacity. So I would say the longer this process goes on the greater the risk of distortions and a much worse adjustment problem later on. If we had begun an orderly decline of the dollar, it will help the problem correct itself before the crisis became relatively severe, but it will not be a totally painless adjustment or transition.

We have had a free lunch for 2 or 3 years, and there is a price paying for that later on.

Mr. VENTO. So you think inflation is one of them. I know you hold out some ray of hope with respect to one of our major imports,

and that is oil. I am a little bit—I can see your point of view, but I see a different point of view, and that is the fact oil prices have been on the decline, at least for us. Because they have been priced by dollar value, they have declined, but they probably haven't declined for Germany, I guess.

Mr. HALE. The magnitude of the problem could lead to the decline of the dollar price of oil even if the dollar falls over. Longer term, if the dollar falls a lot, you may cut the price of oil in Japan and Latin America. In fact, their consumption would rise a lot.

I think in the near term, from talking to people, the supply imbalance is so great, excess supply, we will probably have falling prices even if the dollar adjusts downward.

Mr. VENTO. It is interesting. Obviously, we are getting a double benefit in terms of the increased value of the dollar and conservation, the more-miles-per-gallon automobiles that have been on the market. Instead of importing 8 we are importing 6.3 or something, plus the fact the economy is not back completely to where it was, I guess, during some points in the late seventies, which is a factor on a worldwide or global basis as well.

I guess the question is, in other words, if for instance, all of a sudden OPEC gets its act together, as we know it is capable of doing at some point—that is, Saudi Arabia says we will bite the bullet and do what we want to do, and all of a sudden the dollar decreases in value, we could be facing an increase in the dollar. What will Japan and other industrial nations tolerate in terms of an increase?

Nobody knows what—I guess there are some intangibles in there we can't measure. Nevertheless, that would further accelerate inflation problems domestically. We have now discovered domestic but we have certain limitations in terms of oil production. And with the deemphasis on conservation and other aspects, that seems to have been a characteristic of what has happened in the last 4 or 5 years.

At least that's also troublesome. Well, I think that both the testimony and the work that you are doing with respect to this are very important, and I yield back whatever time I have for any questions.

Chairman LAFALCE. Mr. Carper.

Mr. CARPER. Thank you, gentlemen.

Welcome to our subcommittee hearing. Thank you for your testimony. I missed, I believe, all of your testimony, Mr. Hale. I apologize for that.

What I would like to do is ask each of you the same questions. The first question—keep your answer as short as possible. I may be repeating something in your testimony. The first question is, is the overvalued dollar the chief cause in your judgments of the trade deficit?

Mr. HALE. I think 60 or 70 percent of it, yes, but as a byproduct. Many imbalances attributed to it.

Mr. OSWALD. It is a major factor, maybe 50, 60 percent, instead of 60 or 70 percent.

Mr. CARPER. What are the other primary factors?

Mr. OSWALD. The other factors are certain subsidies on export oriented industries, restrictions on imports, substantial differentia-

tions in wage levels and currency levels not related to changes in value, some of the restrictions of the IMF in terms of requiring some of the debtor countries to import less and export more, a variety of factors.

Mr. CARPER. Mr. Hale.

Mr. HALE. I would agree with that. The dollar was strong in part because the liquidity has been coming here. Because there is no liquidity in Latin America, they can't buy anything. Our deficit has come up because of a lack of commerce, not just because of an overvalued dollar.

Mr. CARPER. The next question: Why is the dollar overvalued? Why do you think the dollar is overvalued?

Mr. HALE. I would give you three or four key factors. It was significantly undervalued in 1979, and second, I believe the 1981 Tax Act significantly increased our tolerance for higher interest rates.

Without fundamentally changing domestic savings behavior because we had, coincident with that, a budget deficit. We became a national capital importer vis-a-vis other countries. Third, other countries have been pursuing restrictive policies. It has been pointed out they have been shrinking budget deficit.

The international action of our very expansionary policy and they are very restrictive policy, again, produced savings their need for capital here, and as it came here, the change rate adjusted. Fourth, the collapse of international bank lending—the money came back here.

Finally, I believe our own Government in the last 4 years—not the most recent statements of people like Clayton Yeutter—was insensitive to the exchange rate question. I think in overreaction to the 1978 rate, they wanted a strong exchange rate and conveyed that. That was a healthy development up until 1981.

After that, we began to be ideological and rhetorical and basically ignored the commercial side of our economy because we were so heavily emphasizing the financial side. Under similar economic circumstances, in 1978, a country like Switzerland actually increased withholding tax, imposed negative insurance rates to protect its industries. America, because of its large borrowing, emphasized its financial interest, the dollar's financial role in the world, at the expense of its commercial role.

I believe the statements of the administration in the last 2 or 3 months indicate a rethinking of that and a better balance. Up until about 9 months ago, you wouldn't have had the U.S. Treasury admit we even had a problem.

Mr. CARPER. Dr. Oswald.

Mr. OSWALD. I agree with everything Mr. Hale said except I am not sure the Treasury admits there is a problem today.

In addition, I would like to emphasize some of the things Mr. Hale maybe said earlier.

The large expenditures for defense in our economy have not been matched by other countries. Japan is a notable example. As we have increased our expenditures for defense, we have had an inflow of funds from abroad for U.S. Treasury notes rather than for actual direct help in paying for the increase in defense for the free world.

The other element that I would just add to what Mr. Hale indicated, domestic monetary policy had been tight to somewhat offset the very loose fiscal policy which has led to much higher real interest rates than we have traditionally had. I find very interesting if one looks at the budget deficit—it is part of the question of this hearing, and of course, it is not a total one for one relationship of that budget deficit. But if you look at the major elements that have caused the \$230 billion budget deficit of today, the change from 1980, it is \$150 billion change—

Mr. CARPER. Excuse me. I am going to interrupt. We are getting far from our question. I have one question to go and not much time. The last question I want to ask Dr. Oswald is specifically, what steps—you may have addressed this in your testimony—what steps must Congress take—not the administration, not the Federal Reserve—what steps must Congress take since we both agree the overvalued dollar is the culprit on this—what steps must the Congress take to bring down the value of the dollar?

Mr. OSWALD. Since the President hasn't acted to put in a surcharge, I believe Congress must act to put in a surcharge to provide temporary relief.

Mr. CARPER. What is temporary relief? How long is temporary?

Mr. OSWALD. One could do it either for a time period or until the deficit has been reduced by 50 percent. So that it is in the neighborhood on the trade side of where it was in 1983, \$70 billion, \$60 billion, instead of \$123 or \$150 billion this year.

Second, we should work to coordinate our negotiations with other developed countries both on the trade side as well as—

Mr. CARPER. What can the Congress do?

Mr. OSWALD. It can direct that this administration undertake actions to coordinate its monetary and fiscal policies in a way with other countries to reduce those imbalances that contribute to the overvalued dollar.

Mr. CARPER. Mr. Hale.

Mr. HALE. Obviously, to cut the budget level and reduce our imbalance. I would say a major role Congress is playing now is frightening the administration to take the whole trade issue seriously. I—

Mr. CARPER. I think I read that.

Mr. HALE. Unfortunately, I have been to Japan several times. I am afraid the Japanese do respond to the threat of trade restrictions. They don't respond to conceptual statements about international cooperation. I believe they will over time.

Their own self-image has lagged way behind what it should be. I think that we have to have in this country much more awareness of the commercial side of our economy that fell by the way side in the last three or four years. I think Congress' role will be to reassert that. I cannot, as an economist, endorse protectionist legislation because that addresses symptoms and not causes. I believe in the current environment, as in 1971, when John Connally acted unilaterally.

You could use protectionism as a negotiating tool to subtract concessions from other countries and to push them to make decisions they might otherwise not make. The problem politically is not to

confuse means and ends. I would see those actions as a means to a bigger end, not as a solution in their own right.

We have to be careful we don't become addicted to solutions in the short-term that create worse problems longer term. I see——

Chairman LAFALCE. One of the advantages of section 122 is it will only permit the imposition of a surcharge for a 5-year period; is that correct?

Mr. OSWALD. Without having Congress extend it, that is correct. To that extent, it would be a means to——

Mr. CARPER. May I ask one more yes or no question?

Chairman LAFALCE. Sure.

Mr. CARPER. It seems to me there may be a conflict between our need to fund the deficit we have and our interest in bringing down the value of the dollar. As the value of the dollar comes down, and interest rates come down, maybe some countries or investors out there abroad will be less likely to help us fund our deficit.

Do you see that as a conflict and a serious problem?

Mr. HALE. It could be a very serious problem, but not this year.

Mr. OSWALD. We could fund our deficit by paying for it.

Chairman LAFALCE. Mr. Hale, on page 13, you suggested the United States and Japan could repeg the dollar and the yen, and we haven't done that. How feasible is that?

Mr. HALE. I think over a 2- or 3-year period, it is somewhat feasible. I think if we had a fundamental change designed to utilize our savings more at home in conjunction with a change in our policy, we could produce an exchange rate.

I doubt we could return to the stability we had in the fifties and sixties. I would point out Europe has done this in the last 5 years. Germany and France have had a close economic relationship—perhaps closer than the United States and Japan, but not that different—and they repeg every few years.

They have had long periods of relative stability and had a consensus on what exchange rate they could live with to maintain free trade between them. America and Japan have a similar relationship. We also deal with Canada, and if we go for a free trade——

Chairman LAFALCE. The type of relationship we have with Canada, I don't recall any repegging of the American dollar——

Mr. HALE. I think as a precondition for having a free trade area, we should insist there be a currency relationship so Canada doesn't run down its exchange rate to saturate our markets with temporary products.

I think that would force Canada to be more disciplined in controlling wage behavior and things like that. I would say an awful lot of countries have tried to resolve their own internal problems through a cheap currency policy. We could, in pursuing free trade talks with them, impose currency conditions.

I think given interaction between Canada and America, the example of the EMS, where you have Germany and France cooperating, is a realistic one to look at. We cannot control capital flows of today's size the way we could 20 years ago. I think we could have an impact on the underlying factors that determine where they go.

Chairman LAFALCE. Do you have information on other countries where they have repegged or where they are able to tailor their ex-

change rate? You mentioned Germany and France. Any other countries?

Mr. HALE. The whole European Community, with the exception of Britain. They repeg it every few years as they need to. The EMS includes Holland, Ireland, Denmark, some other smaller economies. Italy is involved, and Italy has a higher inflation rate than ours. It is an effort to keep that relationship working.

Chairman LAFALCE. Other than for political reasons, would it be that much more difficult for the United States to do it with its largest trading partners?

Mr. HALE. I think, again, if we are willing to address our side of the problem. I talked about Japan's problem a lot, but we also have to address our needs for their savings. We have to fulfill a part of the bargain ourselves. We have talked about constraining Japan's policy.

Have to cut our needs for their savings. I believe we could work out an arrangement over the next 2 or 3 years to correct these problems. I don't believe it is out of our hands.

I think the problem is the Government has been insensitive for a number of reasons, and let the problem get out of hand.

Chairman LAFALCE. Well, our time has expired. We have to get over to the floor for a vote. I want to thank both of you gentlemen for very, very interesting testimony.

This subcommittee will adjourn until Thursday at 10 a.m.

[Whereupon, at 12:10 p.m., the subcommittee was adjourned until Thursday, July 18, 1985, at 10 a.m.]

U.S. DEBT AND THE DOLLAR: THE POLICY PROBLEMS

THURSDAY, JULY 18, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ECONOMIC STABILIZATION,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2220, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Representatives LaFalce, Kanjorski, and McMillan.

Chairman LAFALCE. The Subcommittee on Economic Stabilization will come to order.

Our hearing today will look at the policy alternatives to address the deterioration of our international accounts. At previous hearings we have focused on the seriousness of that deterioration.

The most prominent example of our troubles is the fact that our country is running a trade deficit of \$140 billion a year. Closely tied to that trade deficit, we are borrowing \$180 billion a year abroad. From the end of last year until the end of this year, our country will go from being an international creditor to being the world's largest debtor, and we are expected to double our indebtedness the following year.

On the issue before us today, Fed Chairman Paul Volcker made a number of pertinent points at a hearing yesterday. In the first half of this year, domestic final sales expended at a rate more than 4 percent while domestic output rose around 1.5 percent. This gap between what we bought and what we produced has been growing for some time. As a result, the United States now imports the equivalent of 21 percent of its goods production but exports only 14 percent of its goods production.

At our earlier hearings, some witnesses contended that our credit markets now depend heavily on foreign borrowing. Any significant slowing in the supply of foreign capital would, in their opinion, sharply increase U.S. interest rates and hurt housing and durable goods industries.

Others are less concerned about credit markets than about the displacement of our manufacturing and farming sectors caused by the rising trade deficit. The very sectors that are under trade pressure and cutting back investment are the ones that must be strengthened if we are to service our external debts in the long run.

Economists tell us that our imbalances in trade and external debt trace back to a wide gap between our Nation's savings and investment. This gap cannot last forever. At some point we will be forced to raise savings or lower investment. Many have suggested that the best way to raise our net savings would be for the Government to cut its dissaving or "negative savings" represented by the budget deficit.

Of course, we all would like our adjustment process to be smooth. In recent years, as a number of countries in Europe and Latin America have been weaned away from heavy foreign borrowing and trade deficits, their adjustment has been anything but smooth. I do not want to overdraw the parallels since we obviously enjoy a bigger, stronger economy than any of those other countries. Then again, we do not want to experience anything like what they have gone through, either.

Our room for maneuver is cramped by the slower rate of growth in the U.S. economy. It is much easier to make adjustments in the context of strong growth and falling unemployment than in the current context of 2 percent growth and no progress with unemployment.

Our room for maneuver is also limited on the monetary side. A substantial drop in interest rates could be short-lived. It might cause a drop in the dollar, which would discourage foreign lenders from continuing the capital inflow here. That, in turn, would mean higher interest rates.

At this point in the record I will insert the opening statement of the ranking minority Member, the Honorable Norman D. Shumway.

Statement of the Honorable Norman D. Shumway
July 18, 1985

Economic Stabilization Subcommittee Hearing on
The U.S. Debt and the Dollar: Policy Considerations

Thank you, Mr. Chairman. I would like to welcome our distinguished panel of witnesses today. Their testimony will, no doubt, shed considerable light on the complex issue of the U.S. as a debtor nation, the factors underlying that unique status, their effects on U.S. economic growth and competitiveness and the questions Congress must address to remedy the present imbalances in our economy.

Mr. Chairman, throughout this series of hearings, the noted witnesses have proffered similar explanations for this nation's present debtor status. Nearly all have pointed to the high value of the dollar, high interest rates and the enormous inflow of capital into this country as the major factors contributing to our current economic situation. While the witnesses' analyses have differed somewhat in their emphasis of certain of these elements over others as well as the pros and cons of our "debtor nation" status on U.S. economic performance, all have suggested one measure as the start to solving these problems. That is, reduce the U.S. budget deficit.

I recognize that reducing the federal budget deficit is not the entire prescription for remedying our debtor nation and trade imbalance ailments. But it comprises a primary part of the solution which should neither be overlooked nor ignored. More importantly, it is a prescription that Congress can administer and administer right away. Until we face this challenge, the only things that will be "made in America" will be our budget and trade deficits.

Beyond a tighter fiscal policy, Congress must discourage the outflow of capital. This must entail higher savings and investment -- rather than consumption within this country. Further, it will also require encouraging the economic growth of foreign trading partners whose economies remain sluggish, and consumption by those countries whose levels of saving exceed consumption.

Mr. Chairman, our present situation will not correct itself alone. We must take these steps and we must do it now.

Chairman LAFALCE. Here to discuss potential routes to a smooth, "soft landing" for the United States we have three excellent witnesses today: the Honorable Preston Martin, Vice Chairman of the Board of Governors of the Federal Reserve System; Rudy Penner, Director of the Congressional Budget Office; and Roger Kubarych, now vice president and chief economist at the Conference Board and recently chief economist at the New York Federal Reserve.

Gentlemen, we are delighted to have you with us today.

Gentlemen, we have the entire text of your remarks which we will include in the body of the record, and you may feel free to give them in their entirety or summarize them.

Governor Martin.

STATEMENT OF PRESTON MARTIN, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. MARTIN. Thank you, Mr. Chairman, I will attempt to reach the chairman's goal of 10 minutes.

I appreciate the opportunity to appear on behalf of the Federal Reserve Board, to discuss developments in the external position of the United States, and related policies here and abroad. The value of the dollar, issues affecting U.S. exports and imports and the inflow of foreign capital, are playing increasingly crucial roles in the growth of U.S. output and income.

Domestic fiscal and monetary policies must be implemented with an awareness of our increased and increasing economic and political interdependence. The dramatic appreciation of the dollar and the related trade deficit constrain our economic progress.

The combination of a highly expansionary fiscal policy and disinflation in this country has contributed to strength in the dollar in the exchange markets. The Federal Government has increased substantially its demands for credit to finance its huge deficits. With Federal Reserve policy designed to avoid monetizing the deficit, real interest rates have been higher in the past 5 years than they were earlier. We all know that these high interest rates, together with the initially robust economic recovery in this country, as well as confidence and safe-haven motivations, have produced a record volume of inflow of capital from abroad, a moderation in U.S. capital outflow, and escalation in the foreign exchange value of the dollar.

In turn, the very strong dollar, since 1980, has been a significant contributor to our unprecedented deficits on the trade and current accounts. The rise in the dollar has reduced the competitiveness of U.S. goods as the chairman has indicated, both in foreign markets and in our own back yard.

The expansion bypassed whole industries and entire regions. The growth of our exports has been held back while imports into the United States have grown phenomenally. Economic growth in our trading partners has lagged significantly behind growth in the United States, and their demands for imports have for this reason grown more slowly, and some have argued before this committee that some of those countries have saving surpluses.

The recent revolution in our external situation has been both positive and negative for the United States and world economies.

On the positive side, our Government deficit has been financed at lower interest rates than otherwise would have been the case. At the same time, the sharp increase in our imports has provided needed, even vital stimulus to the world economy, and has been a major factor in the improvement of the balance of payments of heavily indebted developing countries. We have experienced lower inflation rates in the United States than we would have otherwise, and we have given monetary policy a little more action space.

On the negative side, there have been adverse effects on the sectors of the U.S. economy that are most vulnerable to foreign competition, agriculture, manufacturing, and now even the so-called technology-goods producers have lost world and domestic market shares. Forcing our return to competitiveness in many of our industries, these developments have led to the high costs of unemployment, and of the expenditures for retrofitting various types of industrial facilities.

Let me turn to one other implication of our large and growing current account deficit, namely the continuing erosion of the net external financial position of the United States. You have seen the data recently released by the Department of Commerce on the timing of our becoming a net debtor nation. You have alluded to this in your statement, Mr. Chairman. Notwithstanding some statistical issues in timing and measurement, it is clear to me that the United States is now a debtor nation on a net basis, and this situation is likely to deepen, since we continue to run current account deficits of well over \$100 billion a year. You are here asking, how serious is this development?

One answer is that an increasing burden will be placed on current and future generations to service that external debt. This burden will be especially onerous to the extent that foreign funds are financing our current consumption, whether by the governmental or the private sector, since in that case our future standards of living can be adversely affected.

However, there are partial offsets. We most likely have had more investment in this country than we would have had without the inflow of foreign capital, because the additional funds from abroad have most likely reduced real interest rates to some extent. Thus, the inflow of capital has had as its direct or indirect counterpart, some increase in the productive capacity of this country that will in the future facilitate the servicing of the debt.

I want to emphasize, however, that in the policy area we must protect against the risk that the factors inducing investors to bid up the price of dollar assets could reverse abruptly. If this were to happen at a time when credit demands in the country were still strong, especially those from the Federal Government, the resulting pressures on our financial markets could have seriously harmful consequences.

It will come as no surprise to you, therefore, that I join those who urge prompt action to reduce the Federal budget deficits, an essential aspect of the appropriate policy responses to the problems of our twin deficits.

I am inclined to believe there is scope for more vigorous economic expansion abroad. Authorities in other industrial countries have some legitimate concerns with respect to the size of the deficits and

so forth. But these concerns should be balanced by their awareness of costs and dangers of continuing high unemployment in those countries, and continued international imbalances that affect us all.

In the face of the basic imbalances in the United States and in the world economy, a resort to increased trade protection would be pointless and in the long run, counterproductive. The list of reasons for opposing imposition of additional import barriers is well known to the committee. These barriers raise prices facing U.S. consumers and producers, and threaten to reignite the inflation psychology with the possibility of very prompt upward pressure on interest rates, through the expectational side of markets.

Import barriers distort the allocation of domestic resources and can involve significant economic setbacks for developing countries for whom access to markets here and in other industrial countries is vital in economic, social, and political terms.

As to monetary policy, an aggressive policy by the Federal Reserve of massive money growth having as a major objective the reduction of the value of the dollar through bringing down short-term interest rates would set the stage for higher inflation in the future. Excessively expansionary monetary policies, obviously, would not be a solution to the yawning trade deficit. Our experience in the late 1970's taught us all a harsh lesson about the disruptive influence of high and variable inflation in the United States on the domestic and world economies.

This is not to say that the Federal Reserve is indifferent or insensitive to the problems we have been discussing this morning. Repeatedly, the Board and the Federal Open Market Committee have indicated they are taking into account the foreign exchange value of the dollar, international markets, and the international economic situation. We have been explicit in those considerations in our policy deliberations and statements.

But the overriding task of monetary policy is to ensure long-run price stability here, and thereby sustainable long-run economic growth. We cannot afford to jeopardize a successful accomplishment of those tasks.

Mr. Chairman, thank you for permitting me to make this initial statement. I would appreciate your courtesy in putting the whole statement in the record.

[The prepared statement of Mr. Martin follows:]

STATEMENT BY PRESTON MARTIN, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

I appreciate the opportunity to discuss with you this morning, on behalf of the Federal Reserve Board, developments in the external position of the United States and related policies here and abroad. The openness of the U.S. economy is continuously being brought home to all sectors of our economy. The value of the dollar, other developments affecting our exports and imports, and the inflow of capital from abroad play a crucial role in determining the growth and composition of U.S. output and income. Thus our policies must be deliberate, constructive, and far-sighted; the costs over the long run of acting incautiously now are too great.

One of the most significant external economic developments for the United States in recent years has been the dramatic appreciation of the dollar. Since the end of 1980, the international value of the dollar against a weighted average of the other G-10 currencies has appreciated on balance by about 60 percent, despite backing off significantly from its peak earlier this year. The appreciation has been great even after allowing for the somewhat faster rate of increase of prices abroad than in

the United States. The increase in the dollar's value has been greater against European currencies than against the Japanese yen or the Canadian dollar. In a sense, those latter two currencies have been strong, just not as strong as the U.S. dollar.

The factors underlying the dollar's rise are complex. A great deal of the explanation centers on a combination of a highly expansionary fiscal policy and a decline in the rate of inflation in the United States. Reductions in taxes in recent years and increases in government spending have enhanced the attractiveness of investment in this country and have raised overall demands for goods and services. The federal government has increased substantially its demands for credit to finance its huge deficits. With Federal Reserve policy designed to avoid "monetizing" the deficit, real interest rates have been higher in the past five years than they were earlier in the postwar period. These interest rates, relatively robust rates of economic growth in this country (both actual and projected), as well as confidence and more general "safe-haven" factors, have produced a record volume of capital inflow from abroad, a moderation in U.S. capital outflow, and a rise in the foreign exchange value of the dollar.

The extreme volatility in exchange markets earlier this year and especially the dollar's substantial spurt in February provide convincing evidence that expectational and other factors have been at work, as well. However, the decline in the dollar since the end of February probably was related again mainly to more fundamental perceptions -- for example, prospects for lower real interest rates on dollar assets in response to weaker U.S. economic growth and the market's views of improved chances for reducing our budget deficit. Another factor may have been the situation of thrift institutions in Ohio and elsewhere, which received widespread and, perhaps, exaggerated attention abroad.

The rise in the international value of the dollar since 1980 has been a significant proximate factor contributing to our unprecedented deficits on trade and current accounts. From a balance near zero in 1980, the current account has moved to a deficit at an annual rate of about \$125 billion so far this year and is likely to widen still further.

Our current account deficit has reflected primarily the unparalleled increase in our trade deficit, which occurred despite the significant decline in the value of oil imports from \$80 billion in 1980 to less than \$50 billion at an annual rate in the first half of 1985. The rise in the international value of the dollar has reduced the competitiveness of U.S. goods, both in foreign markets and here at home. Thus, the growth of our exports has been held down. At the same time, imports into the United States have grown phenomenally -- by about 65 percent in volume since 1980.

The rise in the dollar has not been the only factor underlying the deterioration in our trade position. Another factor has been that economic growth in our trading partners generally has lagged significantly behind growth in the United States, and their demands for imports have for this reason grown more slowly. Among the industrial countries, this has been especially true in Europe, where growth of real GNP has averaged only about 1-1/2 percent over the past three years. Many developing countries, notably in Latin America, the Far East and Eastern Europe, have adopted

adjustment programs, in order to service their external debts, that temporarily have had an adverse effect on their imports. Weak global demand and high real interest rates made the servicing of their external debts increasingly difficult.

Given the importance of these relative demand factors in the evolution of the U.S. trade position, it is oversimplified but nevertheless instructive, I believe, to characterize external developments over the past few years in the following way. There has been a shift in the demand for claims on the U.S. economy by foreign as well as by U.S. investors that has bid up the value of the dollar sufficiently to generate a current account deficit that corresponds to the desired increase in net claims on the United States. This contrasts with earlier periods, in which it was typically believed that the exchange value of the dollar moved to equilibrate trade or current account positions; when those positions became too large or too small, a change in exchange rates was expected to correct the situation.

The more recent evolution of our external situation has both positive and negative implications for the U.S. and world economies. On the positive side, our government budget deficit has been financed at lower interest rates than would otherwise have been the case. As a consequence, there has been less crowding out in the interest sensitive sectors of the U.S. economy, and, in particular, there has been more private investment and housing activity.

At the same time, the sharp increase in our imports has provided needed stimulus to the world economy and has helped improve the balance of payments of some heavily indebted developing countries.

We also have experienced lower inflation rates than we would have otherwise, given the vigor of the 1983-1985 U.S. recovery and the robust increase in U.S. employment. The cost of the goods we purchase has been lowered -- directly, because of the lower price and ready availability of imported goods and materials, and indirectly, because U.S. producers have been forced to adopt more efficient techniques to modernize and to cut costs, to innovate, and to invest in productivity enhancements to compete

with foreign producers. The rate of U.S. labor productivity increase has improved on balance, although it remains less than that in some of our major trading partners.

On the negative side, of course, have been severely adverse effects on some sectors of the U.S. economy. These are the sectors that are most vulnerable to foreign competition -- both those whose sales abroad have been eroded and those who have lost shares of domestic markets to less expensive foreign products. Agriculture, manufacturing, and even "high technology" goods producers have lost world and domestic market shares. Whereas more than seven million jobs have been created since the end of 1980 in the private service sectors -- which, by their nature, are less open to foreign competition -- the number of jobs in our manufacturing industries has actually declined. Indeed, there is some evidence of U.S. firms beginning to shift some of their investment and production abroad.

Without in any sense denying the social and economic costs that these adjustments entail, I should reiterate, however, that the high value of

the dollar and the external developments I have cited basically have shifted some of the burden of accommodating to the government deficit away from traditional interest-sensitive sectors and toward sectors relatively sensitive to movements in exchange rates. The specific sectoral impacts have been mitigated, but not avoided, by the strong overall recovery.

The severe strains imposed on certain sectors of our economy have contributed to serious pressures for more restrictive trade policies. I will come back to this issue in a few minutes when I discuss alternative policy responses. But it should be clear that such protectionist pressures must be resisted. This follows from our general policy of seeking to enhance the benefits of international trade for our citizens. Moreover, so long as we continue to run a huge federal budget deficit, the inflow of capital from abroad and our access to foreign goods provide welcome relief to our credit markets.

Let me turn now to one other implication of our large and growing current account deficit, namely, the continuing erosion of the net

external financial position of the United States. Data recently released by the Department of Commerce suggest that the United States became a net debtor to the rest of the world sometime in the spring of 1985, falling from a peak position in which the United States had net claims on the rest of the world of about \$150 billion at the end of 1982.

These statistics are subject to a variety of defects. For example, our stock of gold -- amounting to more than 260 million ounces -- is valued in these statistics at about \$42 per ounce, compared with a market price now over \$300 per ounce. Similarly, the stock of U.S. direct investments overseas, as well as foreigners' direct investments here, are expressed only at book value. At the same time, none of the statistical discrepancy in our balance of payments accounts has been counted as net capital inflows, contrary to the conventional wisdom that much of the discrepancy takes that form; to that extent net foreign claims on the United States are understated.

Notwithstanding these statistical issues, it remains clear that if the United States is not now a net debtor country, we probably soon will

be as we continue to run current account deficits of well over \$100 billion a year.

One might ask, "How serious is this development?" One answer is that an increasing burden will be placed on current and future generations to service that debt. This burden will be especially onerous to the extent that foreign funds end up financing current consumption -- for example, by the federal government -- since in that case our ability to consume in the future will be adversely affected. However, I have argued above that we have had more investment in this country than we would have had without the inflow of capital. While it is impossible to know precisely how much more investment we have had, to some extent at least the inflow of capital has had as its direct or indirect counterpart some increase in the productive capacity of this country that will facilitate the servicing of our debt.

Also worrisome is the inference, based on the experience of several developing countries in recent years, that the vulnerability of an economy to shocks can be very sensitive to the level of its net external debt. But there are two major differences between our situation and that of many of

the financially troubled developing countries. First, we are not building up large debts denominated in foreign currencies. Second, creditor confidence in the ability of the United States to service its debts is supported by a healthy, flexible economy with a large and diversified tradable goods sector and a broad and dynamic capital market.

Nevertheless, we must recognize that foreigners will not forever invest an increasing share of their wealth in this country, and we might wonder whether it is appropriate for one of the richest countries in the world to be a net absorber of capital from the rest of the world.

I want to emphasize that we must protect against the risk that the factors inducing investors to bid up the price of dollar assets could reverse abruptly. If that were to happen at a time when credit demands in this country were still strong, especially those from the federal government, the resulting pressures on our financial markets could have seriously harmful consequences. Interest rates would be driven up, private investment would be curtailed, and the housing sector would be hard hit.

It will come as no surprise to you, therefore, that I believe prompt action to reduce the federal budget deficit is an essential aspect of the

appropriate policy response to the problem of our twin deficits. Indeed, action in this area is long overdue. In particular, I believe that progress in controlling the growth of the spending side of the budget is vital. Reductions in the government's demand on savings and on resources tend to reduce pressures on interest rates and to provide scope for strong private investment and employment growth. Such a process would also tend to reduce upward pressures on the dollar and relieve some of the excessive burden on many of our manufacturing firms and on our farmers.

In contrast to the need to tighten the budget position in the United States, I am inclined to believe that there is scope for more vigorous economic expansion abroad. Authorities in other industrial countries have been reluctant to alter existing policies, which have been aimed at disinflation and moderate economic growth over the medium term. They apparently are concerned about the financing of government deficits, about the excessive role of the public sector in economic decision-making, and about the potential that a lowering of interest rates could weaken the value of their currencies and apply upward pressure on domestic prices.

These are legitimate concerns, but they should be balanced by an awareness of the costs and dangers of continued high unemployment and continued international imbalances. Moreover, more rapid expansion in several countries together would be mutually supportive. Tax revenues would be enhanced, and the value of their currencies would tend to move together against the dollar. Indeed, the prospects of stronger economic growth actually could tend to raise the demand for investments denominated in those currencies.

A more vigorous expansion abroad -- together with an improvement in the U.S. fiscal position -- would over time help to redress some of the major distortions in the global economy today. These distortions have adversely affected not just the U.S. economy but the economies of other industrial countries, as well, and have exacerbated the difficult adjustment process now under way in many of the developing economies, especially in Latin America.

In the face of the basic imbalances in the U.S. and world economy, resort to increased trade protection would be pointless and, in the long run, counterproductive. The list of reasons for opposing the imposition of additional import barriers is well known. Import barriers raise prices

facing U.S. consumers and U.S. producers who use imported goods and materials as inputs in production processes. By raising prices, they threaten to reignite the inflation psychology we have struggled so painfully to subdue. Import barriers distort the allocation of domestic resources and enable producers to postpone the investment and rationalization of production that ultimately is necessary. Barriers can involve significant economic setbacks for some of our friends and trading partners -- again, including those in Latin America -- for whom access to markets in industrial countries is vital in economic, social, and political terms.

Trade barriers often violate or undermine international agreements. Especially in such cases, but surely not only then, they are likely to provoke retaliation and so threaten the global trading order on which U.S. exporters and therefore the U.S. economy in general importantly depend.

I have not so far explicitly addressed the role of monetary policy in dealing with our external situation. An aggressive policy by the Federal Reserve of massive money growth to bring down short-term interest rates

in order to reduce the value of the dollar would set the stage for higher inflation in the future. Excessively expansionary monetary policies obviously would not be a solution to the yawning trade deficit. The experience in the late 1970s taught us harsh lessons about the disruptive influence of high and variable inflation in the United States on the domestic and world economies. This experience also has demonstrated the high costs for the economy of substantially reducing inflation once it gains momentum.

This is not to say that the Federal Reserve is indifferent or insensitive to the problems we have discussed this morning. The Board and the Federal Open Market Committee take into account the foreign exchange value of the dollar and the international economic situation explicitly in their policy deliberations. Moreover, to the extent that the dollar and the current account deficit affect U.S. prices, growth, and employment they are taken account of implicitly, as well. But the overriding task of monetary policy is to ensure long-run price stability, and thereby sustainable long-run economic growth. We cannot afford to jeopardize the successful accomplishment of that task.

We cannot deny that we have economic problems. What I have argued this morning is that those problems derive from fundamental imbalances that must be corrected. The search for easy short-term palliatives such as trade barriers or overly expansionary monetary policy cannot ultimately be successful, and will only distract us from the tough decisions that must be made. There are, of course, a number of developments that would help in a real way. I am optimistic that the rapid growth in the U.S. capital stock so far in this recovery and other productivity-enhancing developments will improve the competitiveness of U.S. products in world markets. Moderately faster growth in industrial countries abroad also would help to correct international imbalances. But the most fundamental force behind the problems I have discussed is the huge federal budget deficit, and thus substantial reductions in this deficit offer the best long-run solution to trade imbalances. Although the Federal Reserve will continue to consider exchange rates and trade imbalances in its deliberations, we should not be looked to as a main source of a solution. As I mentioned earlier, any attempt by the Federal Reserve to bring exchange rates down through highly expansionary policies would inevitably lead to more inflation. Thus our best hope for correcting international imbalances lies with efforts by Congress and the Administration to cut federal deficits.

Chairman LAFALCE. Thank you very much. We look forward to the questions, but before that I think it would be appropriate to hear from the other members of the panel collectively. So we will hear from Dr. Rudolph Penner, Director of the Congressional Budget Office, who I think made his maiden appearance before Congress as Director of CBO before our subcommittee about a year or so ago.

**STATEMENT OF RUDOLPH G. PENNER, DIRECTOR,
CONGRESSIONAL BUDGET OFFICE**

Mr. PENNER. Thank you, Mr. Chairman.

I am pleased to be here to discuss the relationship between the budget deficit and the trade deficit. I will be fairly brief in summarizing my statement, which is elaborated in excruciating detail in my testimony.

You would find the conclusions parallel those of Governor Martin's very closely. Although a multitude of forces affect the size of the trade deficit, one of the forces changing the most over the last 5 years has been the size of the Federal budget deficit. As that growing budget deficit emerged, many economists, realizing that it had to be financed by drawing on private or State and local savings, believed that it would crowd out domestic private capital formation and housing. They believed that this crowding out would occur because the shortage of savings resulting from the budget deficit would drive up real interest rates, thus making many potential investments unprofitable.

This simple crowding-out theory, however, failed to recognize the internationalization of our economy and that we are now living in a world of almost perfect international capital markets. When the budget deficit began to put pressure on U.S. capital markets and real interest rates rose in the early 1980's, capital did flow in from international capital markets. Some of that capital came from foreigners and some came from Americans who would have otherwise invested abroad.

This quest to purchase U.S. assets set off a scramble for U.S. dollars and the value of the dollar rose rapidly in foreign exchange markets. This made it more difficult for our exporters to sell abroad, and easier for foreigners to sell in U.S. markets.

A large trade deficit naturally developed, and what many expected to be the crowding out of U.S. capital formation was converted instead to a crowding out of our export industries and those that compete with imports.

Many other factors were at work simultaneously, and I don't want to leave the impression that it was only the change in the budget deficit that created a capital inflow and its counterpart, the trade deficit.

Other factors are elaborated in detail in my testimony, and these include such things as the high level of confidence in political stability and future economic prosperity of the United States; the high level of savings abroad, relative to the demands for savings created by foreign budget deficits and their own private investment levels; and the diminution of inflation in the United States.

The growing trade deficit has resulted in significant imbalances in our economic recovery from the recession trough in late 1982. Those imbalances are not, however, manifested in the broad aggregates of the economy. One would think that because goods are easier to trade internationally than services, the total goods sector would have been badly depressed as the trade sector emerged.

However, the goods sector as a whole recovered from the recession much more rapidly than did the rest of the economy, and the share of goods production and GNP reached levels not experienced since the 1950's. This reflects the fact that goods production is very sensitive to the business cycle and that we have had a very good recovery from a very deep trough.

In addition, defense-related goods production was stimulated by the budget and the tax actions of the 1981 were very beneficial toward capital goods production. Employment in goods-producing industries did not fare as well as production because productivity rose rapidly in the goods sector.

As one looks more carefully at the goods sector, however, it becomes apparent that there are individual subsectors that have been affected greatly by growing imports. They are elaborated in my testimony but among them are industries such as primary metals, textiles, and leather products.

What do we do about all this? If one accepts the above analysis that the deficit has played an absolutely crucial role in explaining the trade deficit, it obviously follows that we must do something about that budget deficit.

As long as it continues to draw capital from abroad, other policy changes such as attempts at protectionism are likely to have only minor effects on overall trade deficits. If imports are successfully restricted artificially, exports are likely to follow concomitantly with resulting significant efficiency losses imposed on the economy.

It should be emphasized that given the large budget deficit as Governor Martin pointed out, capital inflows have been very helpful in keeping interest and inflation rates lower than they would be otherwise.

Now, it would, of course, be too much to expect the trade and budget deficits to move in lockstep. It has been noted that many other factors are also at work and they can either enhance or detract from the beneficial effects of lower budget deficits.

There are also very important time lags that befuddle the key economic relationships. The first response to a depreciation in the dollar is, in fact, likely to be a worsening of the money value of the trade deficit, because at first, import prices tend to rise faster than the physical quantity of imports is reduced. But the volume of imports is likely to respond significantly in about 6 months according to our analysis, and that is what is important to the production of those industries that compete with imports.

I will stop there, Mr. Chairman. Thank you very much.

[The prepared statement of Mr. Penner follows:]

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, it is a pleasure to appear before this Subcommittee to discuss our twin problems of federal and external deficits and debts. In my testimony today, I will discuss several aspects of these problems:

- o The connections among the relevant economic variables;
- o Reasons for our enormous current account deficit; and
- o The impact of the imbalance in our external accounts on the U.S. economy.

I will conclude with a brief evaluation of policy alternatives to deal with the problem of the current account deficit.

FEDERAL AND EXTERNAL DEFICITS IN A GNP ACCOUNTING FRAMEWORK

It is useful to start analyzing the connections between federal deficits and external deficits by reviewing basic national income accounting identities that are, by definition, satisfied in each accounting period. If there were no outside world, federal deficits in any given year would have to be financed by government borrowing from savers outside the federal sector--households, business firms, and state and local governments. This obviously tends to leave less private and public savings available to finance private investment, but in the end, total savings and investment must be equal. One of the ways that investment and savings are brought into

balance is through rising interest rates. ^{1/} To the extent that this depresses private investment, it is often said that "crowding out" occurs.

Why then is widespread crowding out not taking place? After all, despite the enormous federal deficits of recent years, business investment has been very strong and consumer credit demand is at or near record levels. Crowding out has been reduced during the expansion by business tax cuts, accommodative monetary policy, and by other factors as well. A very important reason, however, for the apparent absence of a widespread "crowding out" effect by the enormous federal deficits of recent years has been a net inflow of international capital. This inflow has made it possible for the sum of net private investment plus federal government deficits to exceed the amount of net domestic private savings (inclusive of state and local surpluses).

The Twin Deficits

To simplify our present discussion, state and local surpluses, currently at about 1.4 percent of GNP, will be considered to be part of private savings. Then the basic national income identity tells us that the excess of net private investment over net private saving plus the federal deficit equals

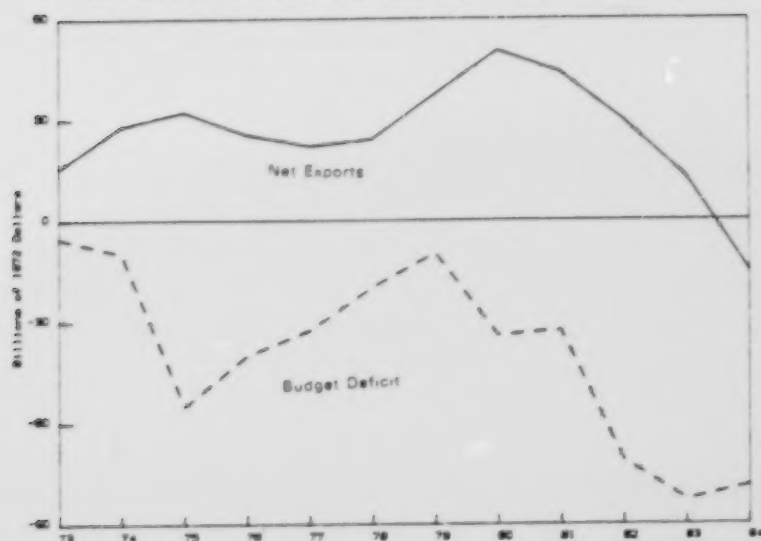
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1. In Keynesian theory, balance can also be achieved because the deficit stimulates production and income. The stimulus proceeds until the savings planned out of enhanced income exactly equals planned investment. However, unless monetary policy is extremely accommodative, interest rates are likely to rise and, as a result, some crowding out of planned investment is probable.

the supply of saving from abroad. The basic balance of payments identity tells us, in turn, that the net inflow of international capital must be matched by a current account deficit.

Assuming that there are no imperfections in reporting and collecting the pertinent data, national income accounting identities leave no room for doubt that federal deficits and external deficits are very tightly connected. In fact, were it not for variations in net private domestic saving and investment, any change in the federal deficit would, after the fact, be reflected exactly in the current account deficits. Figure 1 depicts recent behavior of the two deficits. As can be seen, the correlation between the two measures, while far from perfect, is unmistakable.

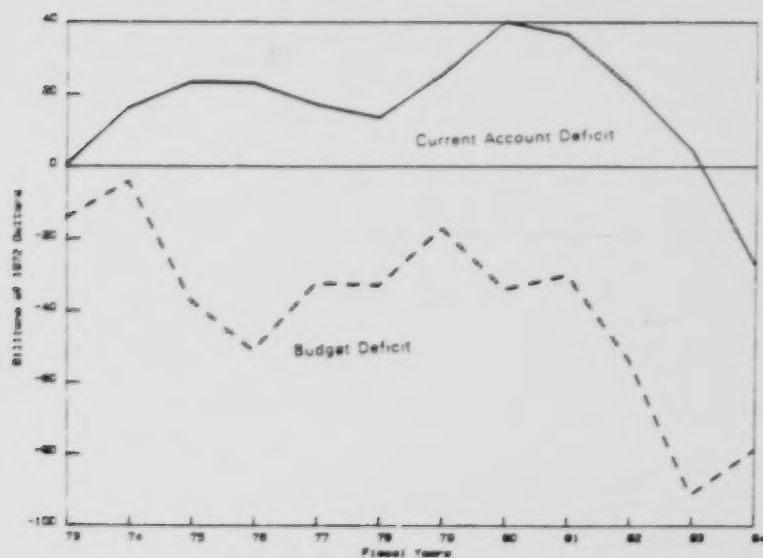
To find a connection between two economic aggregates is, of course, much easier than to identify the precise nature of a causal link between them. The distinction is crucially important for designing sound public policies. For example, over the last year, the increase in our current account deficit was noticeably more pronounced than the widening of the federal deficit. Because of changes in private investment or savings, the very nature of the connection between the two variables leaves plenty of room for such divergences. Nonetheless, some observers maintain that our foreign trade deficit has little to do with our fiscal policies. They claim that these deficits are solely the result of, say, superior growth prospects and investment opportunities in the United States compared with abroad, and that a change in our fiscal stance would have no significant

Figure 1-A.
U.S. Budget Deficit and Net Exports (NIPA Basis)



SOURCE U.S. Department of Commerce

Figure 1-B.
U.S. Budget Deficit and Current Account Deficit (Unified Budget Basis and Balance of Payments Basis)



SOURCE U.S. Department of Commerce.

effect on the eagerness of foreigners to lend to Americans. Others attribute our deficits predominantly to unfair trade practices in other countries and call for dealing with the external deficit problem by restricting imports of goods or capital from abroad. While all foreign countries engage in some protectionist practices, it is impossible to explain the large increase in our trade deficit by an increase in foreign protectionism.

These, and other, explanations for our mounting external deficits are superficially appealing because all of them contain an element of truth. After all, America enjoyed higher rates of growth in recent years than most other countries, and foreign investments in the United States are generally treated more hospitably than almost anywhere in the world. These facts do not, however, refute the view that federal deficits in recent years contributed importantly, I would even say decisively, to the unprecedented deterioration of our foreign trade and current accounts.

REASONS FOR CAPITAL INFLOWS

As suggested above, our current account deficit represents the net amount of resources foreign residents are willing to lend to us every year plus the amount of American-owned assets abroad that U.S. investors are willing to bring home. A question that needs to be explored is: why do international capital owners prefer to place their savings in the U.S. rather

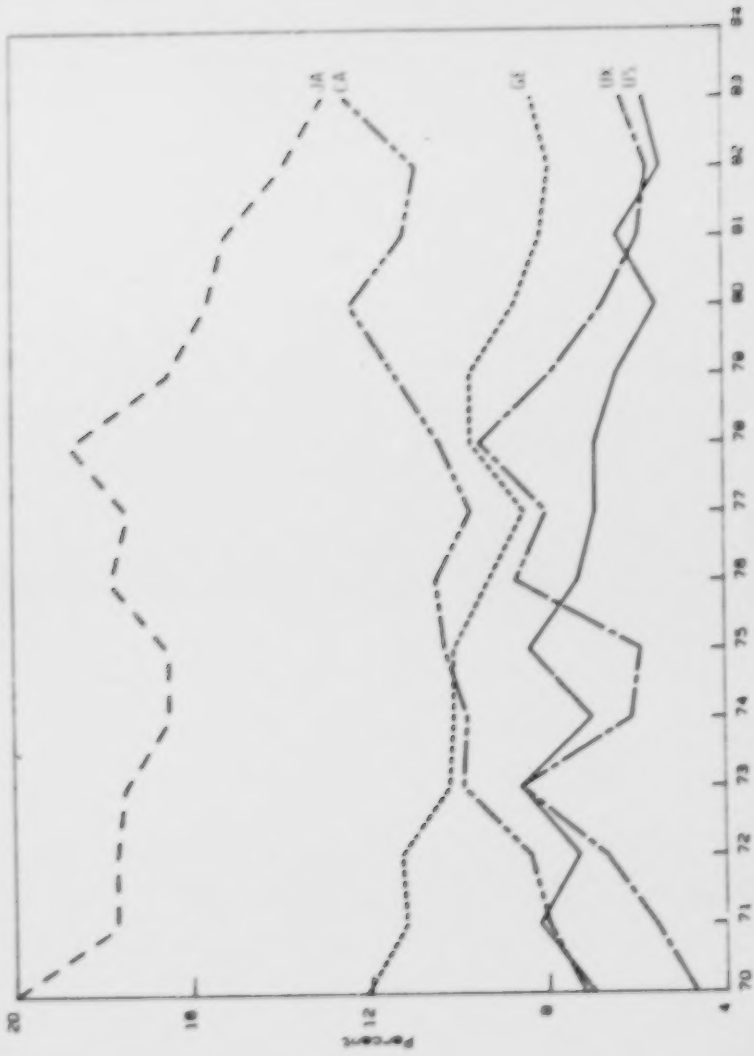
then to keep them in other countries." Those factors that are responsible for pushing capital out of the countries where saving is generated can be labeled the "push factors"; those responsible for drawing this capital into the United States can be labeled the "pull factors."

The Push Factors

All else being equal, it is obvious that a high level of net private domestic savings in a country makes it more likely to become an exporter of capital. Indeed, as Figure 2 demonstrates, households and businesses in other major industrial countries--the major sources of capital flows into the United States in recent years--save considerably more than their American counterparts. By contrast, as Figure 3 illustrates, the ratio of the U.S. federal government deficit to GNP has risen sharply in this decade, while the corresponding average ratio for other major industrial countries has remained more or less constant.

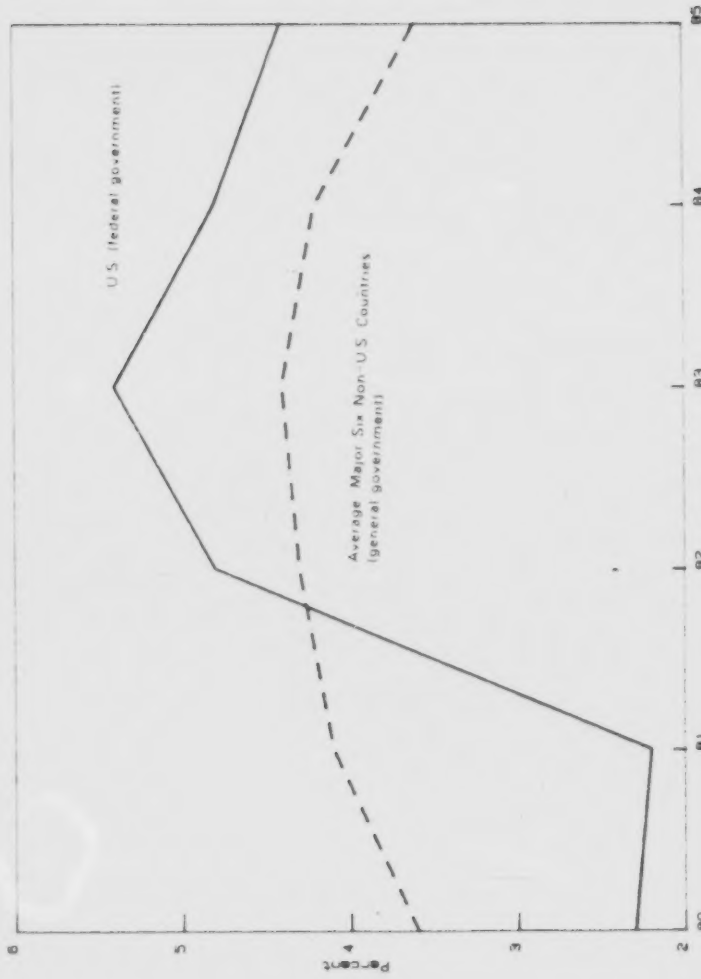
A high level of private saving and a relatively low level of public sector borrowing leaves abundant resources for domestic investment. By and large, however, investment in most industrial countries outside the United States has been weak until very recently. The main reason for this weakness has been sluggish growth in virtually all industrial countries. Until last year, their rates of real growth were well below those enjoyed by the United States (see Figure 4). Slow growth and a high degree of underutilization of resources are, understandably, not conducive to strong

Figure 2.
Net Private Saving as a Percentage of GDP



SOURCE: Wharton Econometric Forecasting Associates, Inc.

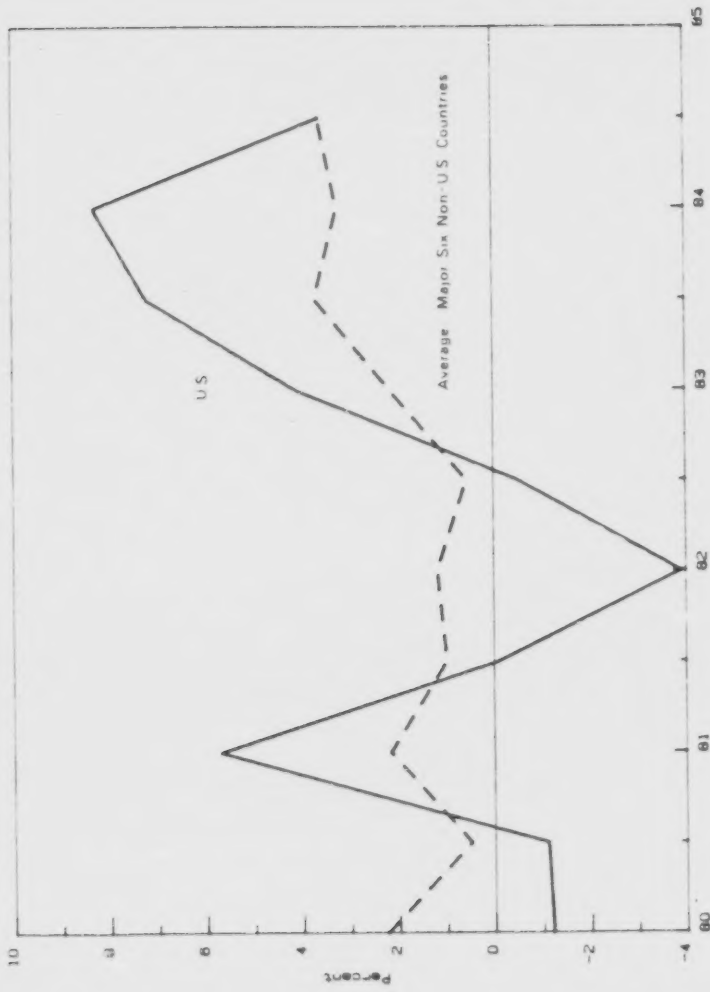
Figure 3
Budget Deficit as a Percentage of GNP/GDP (NIPA Basis)



SOURCE Organization for Economic Cooperation and Development staff estimates and forecasts Congressional Budget Office

NOTE Major six non-U.S. countries are Japan, West Germany, France, United Kingdom, Italy and Canada

Figure 4.
Real GNP/GDP Growth



SOURCE Organization for Economic Cooperation and Development

investment. In addition, in the European Economic Community in particular, investment is dampened by long-term structural rigidities in labor markets and the over-regulation of business activity.

With high private saving rates, relatively tight budgets, and low levels of investment, Japan and the countries of Western Europe have become a major source of savings to the world. Latin American and East European countries, as a group, have also recently become net savers--a sharp reversal of their position as major importers of foreign capital in the 1970s.^{2/} This reversal is partially the result of the drastic reduction in lending by U.S. banks to them, and some repayment of earlier debt. Nonetheless, on a net transactions basis, the effect is just as if they had turned from a neutral position to one of substantial providers of savings to the rest of the world.

Finally, since the early 1980s a marked shift may have occurred in international investors' preferences in favor of dollar-denominated assets. This shift is said to result from such considerations as political instability in many parts of the world, and intermittent fears of expropriations, exchange controls, and other actions generally viewed as being unfavorable to business. While the resilience the dollar has displayed until very recently in foreign exchange markets gives some credence to these explanations, it is difficult to say to what extent these factors have played an independent role in pushing capital out of the countries of its origin.

2. On the other hand, the 1980s witnessed virtual exhaustion of the major source of saving in the 1970s--the OPEC current account surpluses.

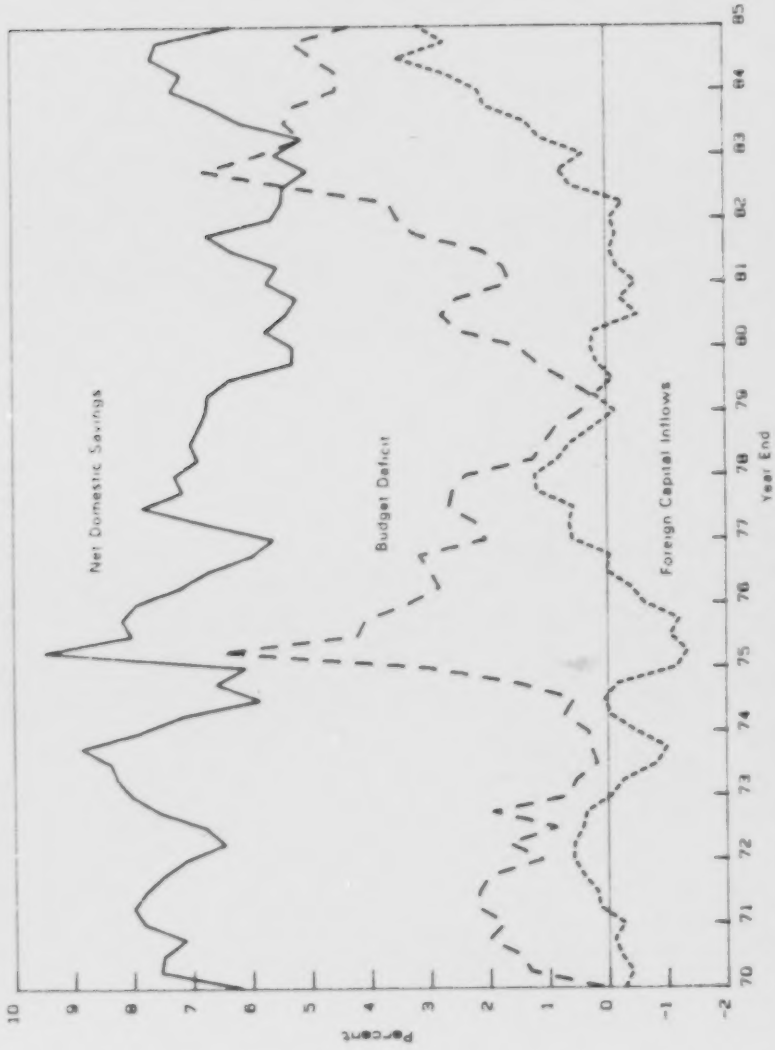
The Pull Factors

One major factor responsible for attracting capital from the rest of the world into the United States is the low level of saving by Americans. As I noted earlier, the saving ratio in the United States is the lowest of any major industrial country. Furthermore, as Figure 5 indicates, the trend of domestic savings in the United States does not appear to display any correlation with the trend of federal deficits. ^{3/}

All other things being equal, a low saving ratio tends to make capital scarcer and its price--that is, the real interest rate--higher. In a world of high capital mobility, that alone will attract capital generated in other countries. But the differentials between U.S. savings ratios and those of other countries were about the same throughout the 1970s as they are today. Yet, international investors felt no urge to invest massively in the United States (see Figure 5). The cause of this sharp difference in the patterns of capital flows between the 1970s and the 1980s is that few other important things have remained equal.

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3. This observation is important in light of a frequently heard, so-called neo-Ricardian argument. According to this argument, if the increased government borrowing stems from a tax cut, then after-tax private incomes would rise by the same amount. If people expect that increased government debt would have to be serviced by future tax increases, they will decide to save most, perhaps all, of the increase in their after-tax income. As a result, net borrowing needs by the private sector will be reduced accordingly, partially mitigating (or even totally offsetting) the impact on interest rates of larger federal borrowing. Even a weak confirmation of the neo-Ricardian hypothesis would at the minimum require that the trends of (cyclically adjusted) federal deficits and net domestic saving ratios be positively correlated.

Figure 5
Domestic Savings, Budget Deficits, and Foreign Capital
Inflows (Percent of GNP, NIPA Basis)



SOURCE U.S. Department of Commerce Congressional Budget Office

In my opinion, the most important difference by far between the 1970s and today is a sharp rise in cyclically adjusted federal deficits, both in current dollars and, more crucially, relative to GNP. As Figures 6 and 7 illustrate, since 1981 this rise in deficits has continued through both a deep recession and a vigorous expansion. Equally important, unless current policies change, under any reasonable projections, this rise in the structural deficit will continue unabated through the remainder of this decade.

Economic theory suggests that such rises in current and expected deficits should raise real interest rates. While real interest rates have in recent years been considerably higher than in preceding decades (see Figures 6 and 7), there are substantial disagreements among economists about the extent to which federal deficits are responsible for the high level of real interest rates or for their fluctuations. A few economists believe that there is no relationship, while others debate whether it is the size of the deficit or the level of the total public debt relative to private wealth that is important. Empirical studies have been unable to resolve this dispute because of the difficulty of separating the effects of changes in fiscal policy from the multitude of other factors affecting interest rates. ^{4/}

4. An analysis of the link between federal deficits and interest rates, and more specifically of the reasons for the apparent difficulty in obtaining solid empirical confirmation of the prevalence of such a link can be found in The Economic and Budget Outlook, Fiscal Years 1986-1990, Congressional Budget Office (February 1985) pp. 81-84 and pp. 93-95.

Figure 6.
U.S. Budget Deficit and Real Interest Rates (Unified Budget Basis)

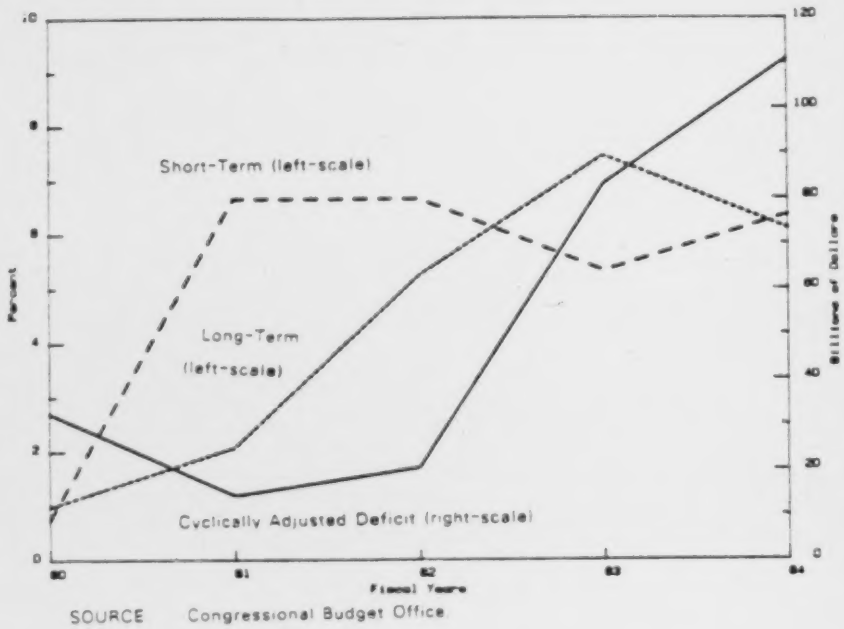
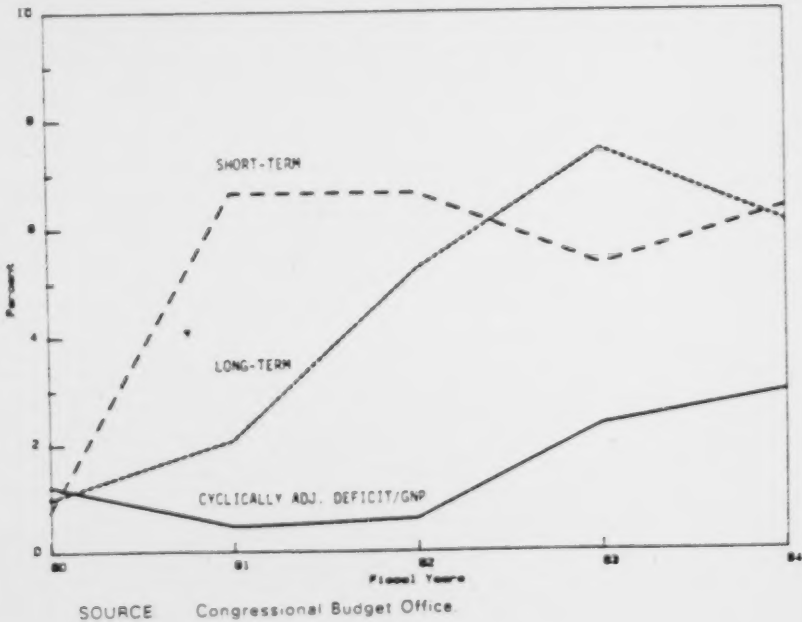


Figure 7.
U.S. Budget Deficit and Real Interest Rates (Unified Budget Basis)

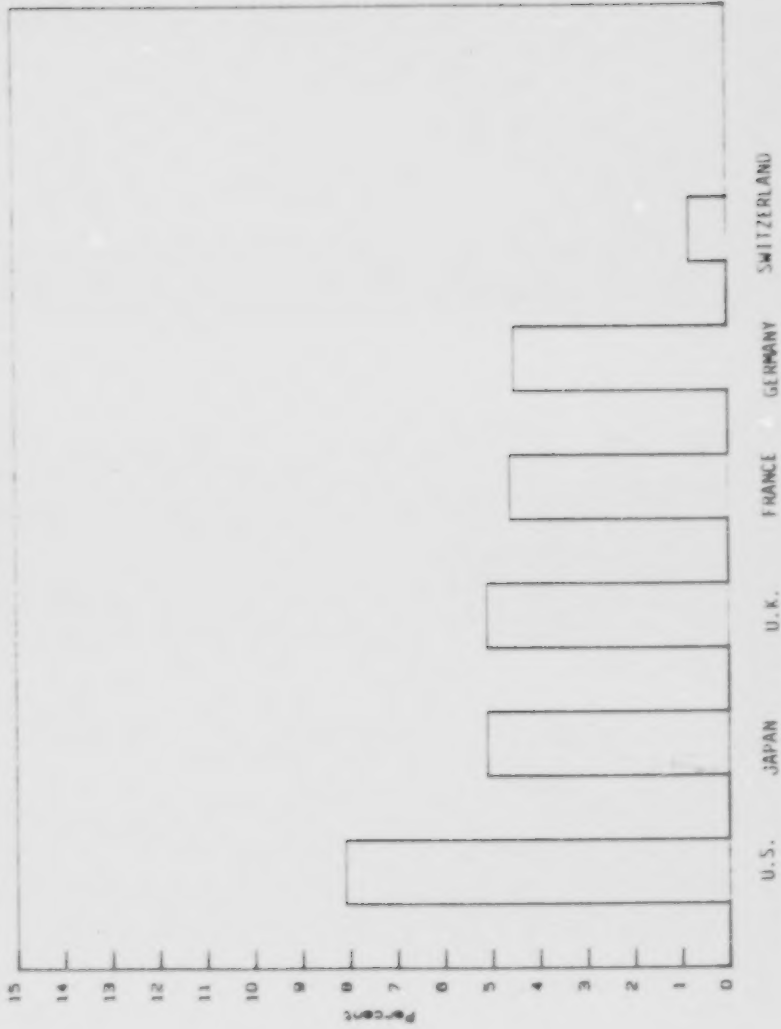


Nevertheless, common sense and economic theory suggest a relationship. Moreover, theory is particularly persuasive in enunciating a long-term link between real interest rates and the stock of public debt. ^{5/} Thus, it is likely that the strong upward trend in the debt-to-wealth ratio has exerted continuous upward pressures on U.S. real long-term interest rates, leaving them for the most part considerably above interest rates in other major industrial countries (see Figure 8). ^{6/} This interest rate differential provided an important attraction for dollar denominated investments relative to investments denominated in other currencies.

Another pull factor resulted from a series of changes in the U.S. tax code since 1981. The most significant were the Accelerated Cost Recovery System combined with the investment tax credit and the recent repeal of the tax withholding provisions on interest and dividends earned by foreign residents on their U.S. investments. These tax changes increased the real effective rate of return on U.S. investments relative to investments in other countries and thereby reinforced the attractiveness of relatively high pre-tax rates of return available in the United States.

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5. In the short run, deficit-to-GNP and debt-to-GNP ratios can move in opposite directions. In fiscal year 1984, for example, the deficit relative to GNP was lower than in the prior year, but the debt-to-GNP ratio rose nonetheless.
 6. The increase in this ratio would have been considerably larger were it not for large capital gains realized by the public since mid-1982 on stocks and bond holdings. On the other hand, the increase in the market value of residential real estate (which is a very substantial component of private wealth) has been very modest in the last several years.

Figure 8
Real Long Term Interest Rates (1982-1984 Average)



SOURCE Bank for International Settlements

The attractiveness of the United States as a place to invest has undoubtedly been reinforced by the success of the Federal Reserve in subduing inflation. The actual rate of inflation declined dramatically since 1980 and stabilized at what, by the standards of the last decade, is considered a moderate level. Further, the policy stance of the Federal Reserve has been perceived as demonstrating continuing anti-inflationary resolve. Although inflationary expectations are extremely difficult to gauge, it seems fair to say that the conduct of U.S. monetary policy in recent years substantially alleviated fears of international (and domestic) investors of a sudden and abrupt loss of purchasing power of American currency. Restoring confidence in the dollar could only have an additional positive impact on the relative attractiveness of U.S. investments.

International investors have also been attracted to the United States as a result of its superior growth performance. One may argue that rapid growth is not an independent factor but rather a result of policies and circumstances such as those discussed above. Whatever the reason for rapid U.S. economic growth in recent years, an expanding economy creates ample investment opportunities, generally reflected in a rapid cyclical growth of domestic net investment.

The long-run growth prospects of the American economy are enhanced by the flexibility of U.S. labor markets and reduced business regulation. It is obvious that factors of this nature make the United States more attractive than it would be otherwise, but it is difficult to assess their quantitative importance.

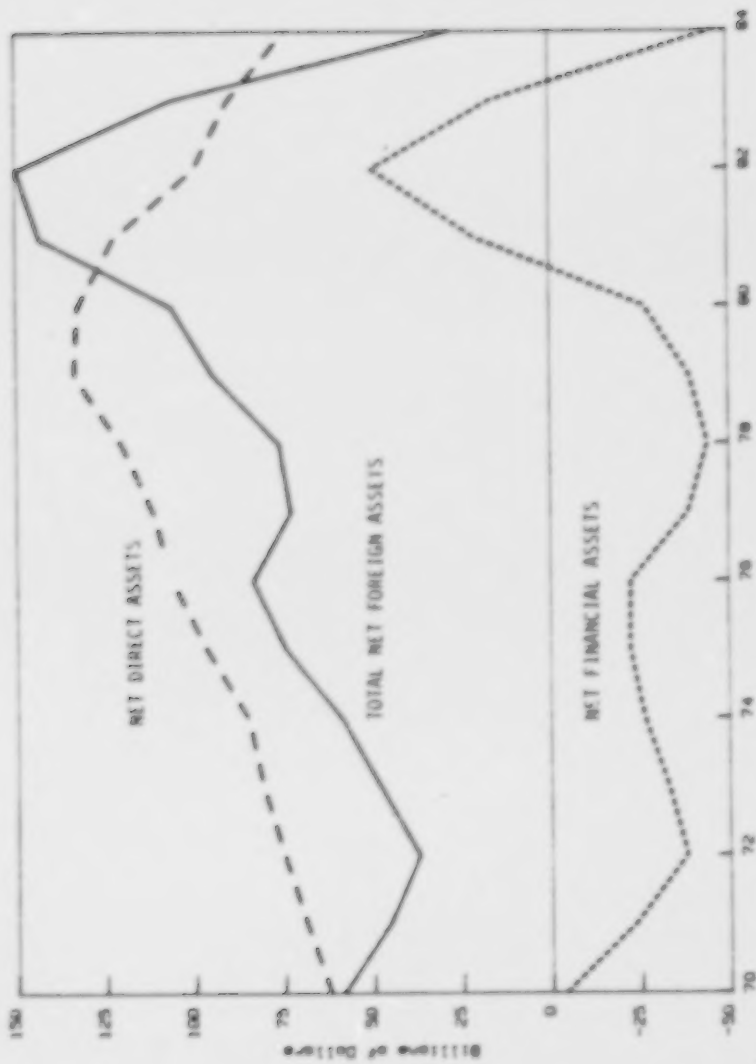
Other factors thought to be conducive to foreign investment in this country include political and institutional stability in the United States, territorial security, and a favorable business climate. These factors are, of course, very important to international investors. Measuring their importance is, however, virtually impossible.

In summary, a large number of factors have been working to push and pull international capital toward the United States. Since the late 1970s, however, the federal deficit has grown to levels unprecedented in peacetime history while the trade deficit has moved concomitantly. It is, therefore, difficult to believe that the size of the budget deficit is not a very important, or perhaps the most important, force behind the deteriorating trade balance.

THE IMPACT ON THE U.S. ECONOMY

The enormity of the flow of international capital into the United States is illustrated in Figure 9 and Table 1 summarizes the story. In barely two and a half years, U.S. net foreign assets fell from their peak value of \$150 billion (which took a generation to accumulate) to zero. Secretary of Commerce Malcolm Baldrige confirmed a few weeks ago that early this year the United States had become a net debtor nation. Data in Table 1 indicate that over the last four quarters for which data are available, net

Figure 9
U.S. Net Foreign Assets



SOURCE U.S. Department of Commerce

TABLE 1 INTERNATIONAL CAPITAL FLOWS (In billions of dollars, seasonally adjusted)

	1983	1984	1984				1985 ^a
			I	II	III	IV	I
<u>Change in Foreign Owned U.S. Assets (a)</u>	81.7	97.3	19.3	41.6	3.1	33.3	16.5
Official Foreign Assets (b)	5.3	3.4	-2.8	-0.2	-0.7	7.1	-11.4
Private Assets	76.4	93.9	22.1	41.8	3.8	26.2	27.9
Direct investment	11.3	22.5	3.3	9.3	5.2	4.7	2.7
Treasury securities	8.7	22.4	1.4	6.5	5.1	9.5	2.7
Other securities	8.6	13.0	1.5	0.5	1.6	9.4	9.5
Other reported by nonbanks	-1.3	4.3	4.5	4.6	-2.9	-1.9	n/a
Other reported by banks	49.1	31.7	11.3	21.0	-5.1	4.5	13.0
<u>Change in U.S. Owned Foreign Assets (c)</u>	49.5	20.4	5.0	19.0	-18.4	14.8	3.2
U.S. Government Assets (d)	6.2	8.6	2.7	1.9	2.2	1.8	1.0
Private Assets	43.3	11.8	2.3	17.1	-20.5	13.0	2.2
Direct investment	4.9	4.5	3.1	-2.0	-2.0	5.4	-0.6
Securities	7.7	5.1	-0.7	0.8	1.3	3.7	2.5
Other reported by nonbanks	5.3	-6.3	-1.3	-1.9	-2.1	-1.0	n/a
Other reported by banks	25.4	8.5	1.1	20.2	-17.7	4.9	0.3
<u>Net Capital Inflows on a Reported Basis (e = a - c)</u>	32.2	76.9	14.3	22.6	21.5	18.5	13.3
Net official capital inflows (f = b - d)	-0.9	-5.2	-5.5	-2.1	-2.9	5.3	-12.4
Net private capital inflows (e - f)	33.1	82.1	19.8	24.7	24.4	13.2	25.8
<u>Statistical Discrepancy (g)</u>	9.3	24.7	4.8	1.9	11.0	7.0	16.7
<u>Net Capital Inflows Including Statistical Discrepancy (h = e + g)</u>	41.6	101.5	19.1	24.5	32.5	25.5	30.0
Net official capital inflows (f)	-0.9	-5.2	-5.5	-2.1	-2.9	5.3	-12.4
Net private capital inflows (h - f)	42.4	106.8	24.6	26.6	35.4	20.2	42.4

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis

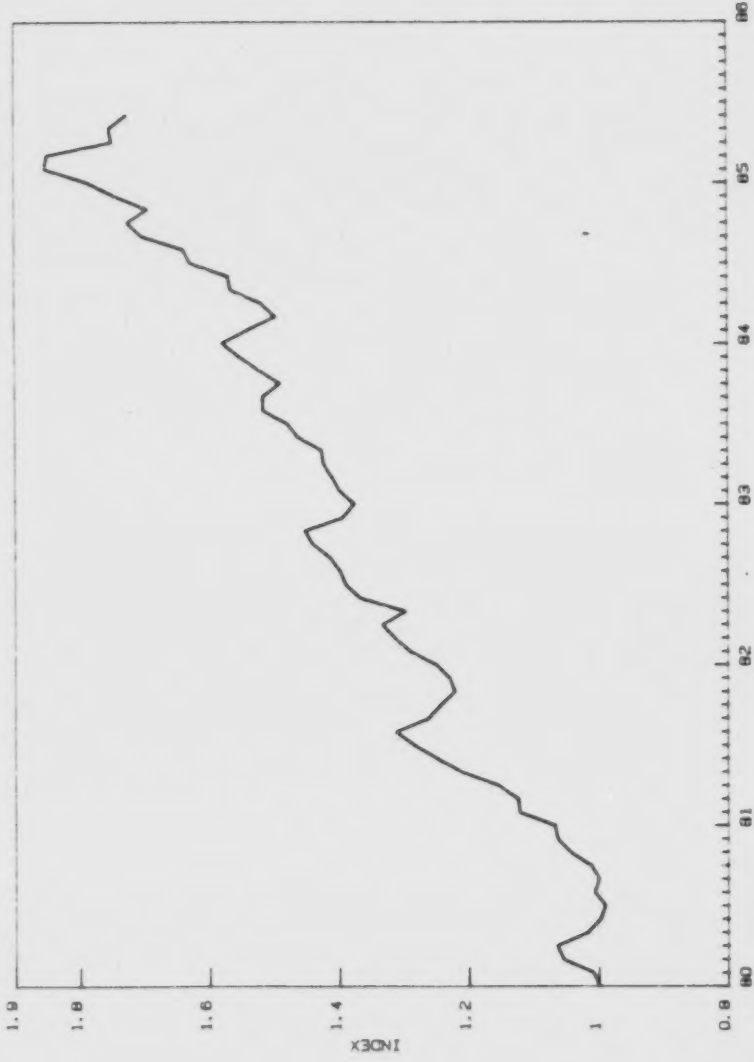
^a Preliminary data.

capital inflows into the United States on a reported basis averaged almost \$6.5 billion a month. If the category "statistical discrepancy" as a proxy for unreported capital flows is included, net capital inflows over the last four quarters average almost \$9.5 billion per month. Even these enormous capital inflows probably understate worldwide private demand for dollars. In recent years, the increase in the value of private dollar liabilities in the Eurobond and Eurocurrency markets (exclusive of interbank deposits) have exceeded by a large margin the depletion of dollar-denominated assets held by foreign governments.

Conversions of other currencies into dollars on the magnitude suggested by the size of net capital inflows into the United States have had a dramatic effect on the exchange rate of the dollar. As Figure 10 illustrates, the effective exchange rate of the dollar (as measured by the Federal Reserve Board) rose from 1980 through the first quarter of 1985 by over 85 percent in nominal terms (and by about 70 percent in real terms), before dropping in the last few months.

It is worth pointing out that capital flows from abroad have helped a great deal to keep U.S. interest rates below what they would have been otherwise. Similarly, the appreciation of the dollar accompanying these inflows has helped to keep inflation below what it would have been otherwise. Without these capital inflows, the adverse impact of the mounting federal debt on long-term growth prospects of the economy would

Figure 10.
Nominal Effective Exchange Rate



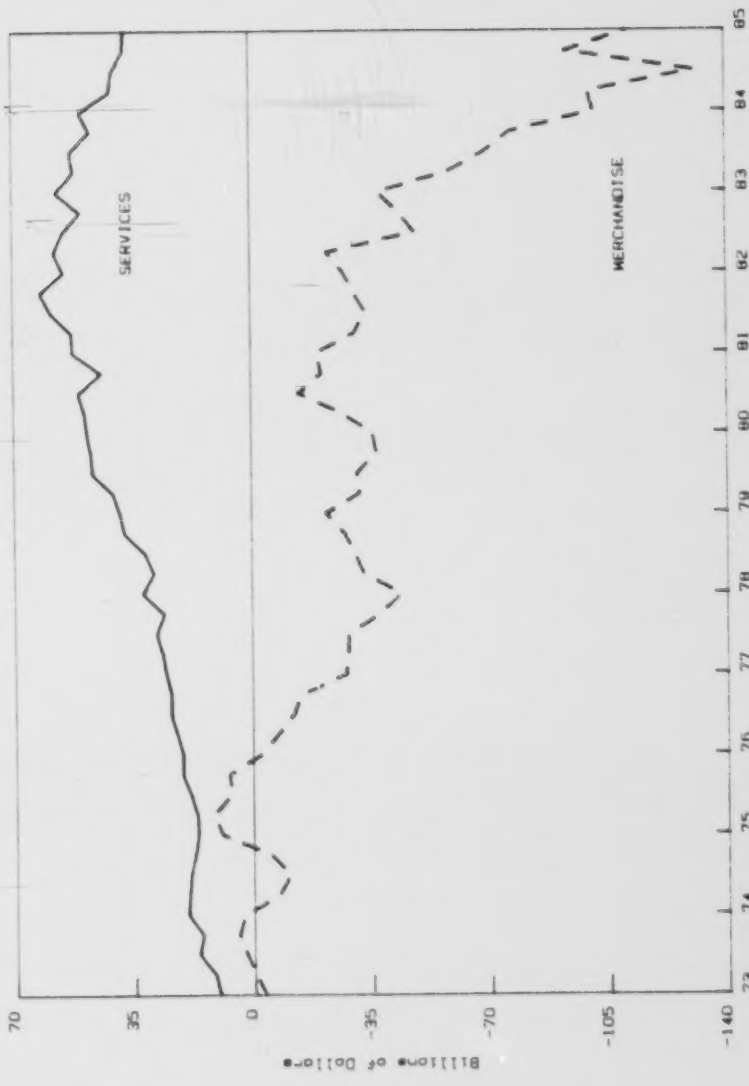
SOURCE: Federal Reserve Board

have been much more pronounced, because the crowding out of U.S. capital formation would have been greater.

A counterpart of these capital inflows and a partial result of the simultaneous appreciation of the dollar has been a massive deterioration of our foreign trade and services balances, a deterioration that is expected to continue for some time even if the dollar depreciates further (see Figure 11). The same picture of an entirely unprecedented deterioration in our external accounts can be seen in Figure 12. As a percentage of GNP, our current account deficit this year would be about three times larger than anything this nation has experienced in the 60 years prior to 1981, including periods of wars.

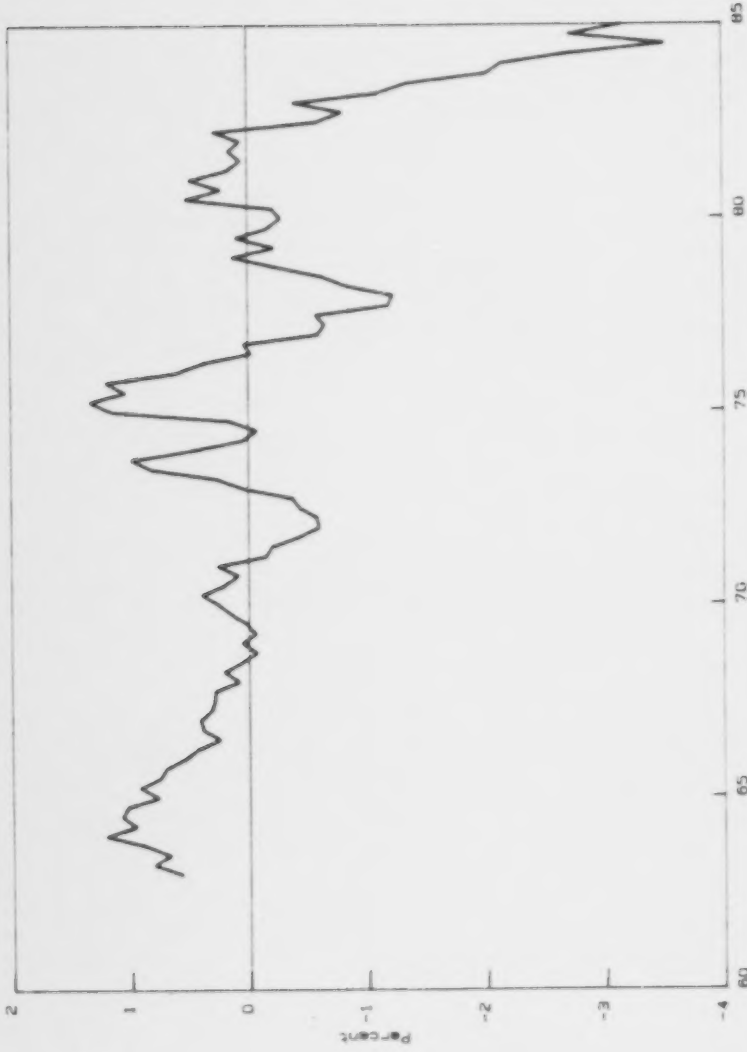
Has the deterioration in our external account affected the rate of growth of the U.S. economy? If, as argued above, increased federal deficits have been crucially important in creating the trade deficit, the depressing effect of the trade deficit cannot be viewed in isolation from the stimulative effect of the budget deficit. However, numerous complicating forces, also discussed earlier, prevent the federal deficit and the trade deficit from moving in lock step. Data suggest that the increasing drag on the economy originating in the external sector was more than offset, especially until mid-1984, by stimulative effects of the ongoing fiscal expansion. More recently, the negative effects of rapidly deteriorating net exports appear to have dominated fiscal policy impacts, thus depressing overall U.S. economic performance.

Figure 11
U.S. Merchandise Trade and Services Balances (NIPA Basis)



SOURCE U.S. Department of Commerce

Figure 12.
U.S. Current Account as a Percent of GNP



SOURCE U.S. Department of Commerce

Trade Deficits and the Composition of the Economy

A separate aspect of the rising deficits in our external accounts is its impact on the composition of domestic output and on particular sectors of the economy. As seen in Figure 11, the deterioration in merchandise trade was much more pronounced than that in the services account. Other things being equal, this would lead one to expect a dramatic deterioration in the relative share of goods output in total GNP. Additionally, as is normally the case with impacts of foreign trade on the domestic economy, one would expect to notice a wide variance of effects across detailed industries.

Stagnation in Traded Goods Industries?

Surprisingly, as shown in Figure 13, the goods share of total real GNP actually reached a 30 year high in 1984, with only a slight decline in the first quarter of 1985. The rise in the goods output share was matched by a large decline of share for services, and an improvement in the share of structures from the very low level reached during the 1982 recession.

Goods output appears to have followed quite closely its normal movement relative to the business cycle. Since goods output tends to consistently respond in a stronger fashion than does nongoods output to cyclical changes in GNP (see Table 2), the unusually large goods share of total output could have been predicted based on relationships from previous recovery experiences, given that the 1984 real GNP growth rate of 6.8 percent was the highest attained since 1951. At face value, the evidence

Figure 13.
Sectoral Shares of Total Real GNP

Major Production Groups

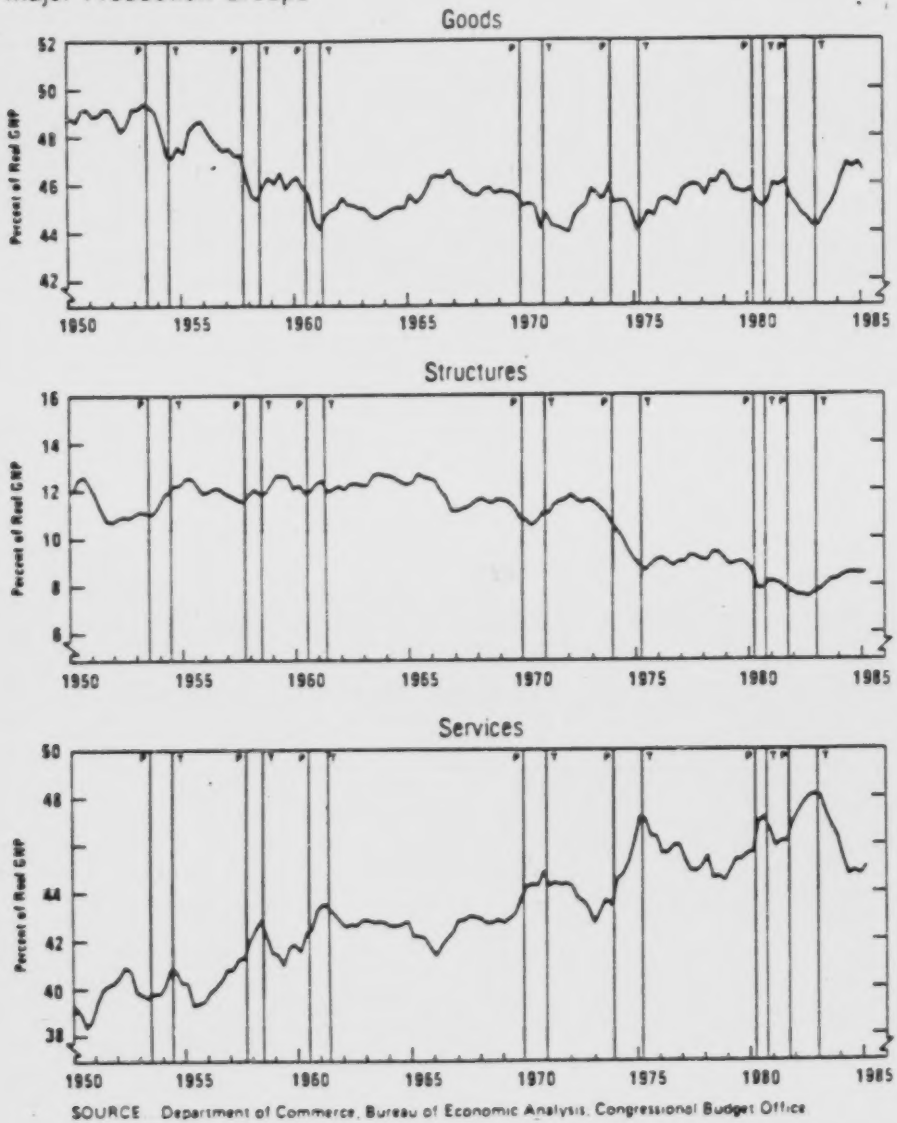


TABLE 2. REAL DOMESTIC GOODS OUTPUT AND THE REAL MERCHANDISE TRADE DEFICIT (NIA basis, annual rates)

	(1) Real GNP (Percent Change)	(2) Real Goods GNP (Percent Change)	(3) Change in Real Goods Output (billions of 1972 dollars)	(4) Change in Real Net Merchandise Exports (billions of 1972 dollars)
1973	5.8	8.1	42.7	8.0
1974	-0.6	-1.7	-9.8	7.4
1975	-1.2	-2.7	-15.1	6.6
1976	5.4	7.3	39.8	-9.0
1977	5.5	7.0	40.9	-5.7
1978	5.0	5.4	33.9	-1.1
1979	2.8	2.4	15.7	7.1
1980	-0.3	-1.4	-9.6	11.5
1981	2.5	3.7	25.0	-7.2
1982	-2.1	-4.7	-32.5	-9.5
1983	3.7	4.2	28.0	-14.1
1984	6.8	11.0	76.0	-21.4

1985:1	0.3	-2.9	-5.8	-14.3

SOURCES: Bureau of Economic Analysis, U.S. Department of Commerce and Congressional Budget Office.

seems to show that goods share continues to be dominated by domestic cyclical movements, even in the face of the concurrent record merchandise trade deficits.

In fact, though, the story is more complicated. To properly assess the impact of the trade deficit on the composition of output in the economy, it is necessary to ascertain the degree to which a trade deficit exerts downward pressure on demand for goods relative to nongoods output, and then to analyze why this pressure is not currently reflected in broad sectoral trends.

In general, a merchandise trade deficit develops either because domestic economic growth outpaces foreign growth, or prices for domestic goods rise relative to foreign goods. A trade deficit need not produce downward pressure on demand for domestic output. It depends on the cause of the deficit. Imports increase normally relative to exports during periods of domestic economic growth, as domestic spending increases on all goods. Trade deficits normally occur during recovery stages of business cycles, when domestic output is growing at its most rapid pace. On the other hand, trade deficits that result because of weak foreign growth, or losses of price competitiveness (for example, as a result of exchange rate appreciation) do tend to lower demand for domestic output. Studies have shown that most of the recent increase in the merchandise trade deficit was of the latter form,

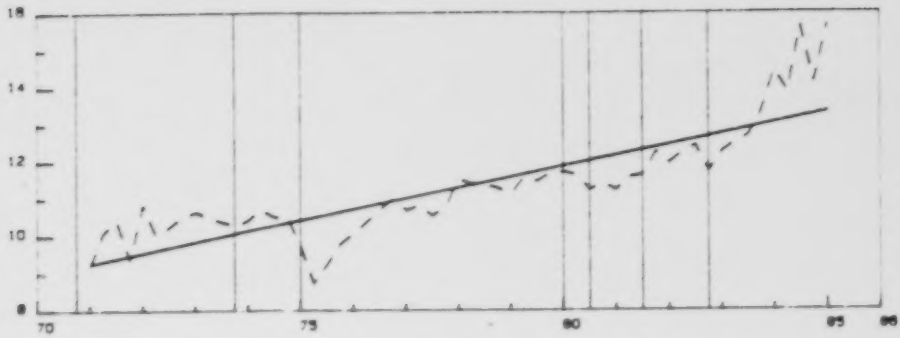
exerting downward pressure on demand for domestic output of goods. ^{7/} This effect is illustrated in Figure 14 by examining ratios of import penetration and ratios of export contribution to demand for domestic output, which appear to be above and below trends respectively. Thus, a large proportion of the increase in the trade deficit, even accounting for the effect of the high domestic growth, should tend to reduce demand for domestic goods production and the goods share of total real GNP, all else held equal.

But all else was not held equal. Most important, both the large increase in defense spending and the impact of lower effective tax rates on personal income and investment spending during this period contributed to an increase in demand for goods relative to nongoods output. To date, no estimate is available for the impact of these fiscal policies relative to the trade deficit. It is likely, however, that the goods share of GNP would have been below its trend-adjusted level had not other policies offset the impact of the record trade deficit. In addition, since the full effect of exchange rate changes occurs slowly over time, the rapid dollar appreciation in 1984 is likely to continue to be felt throughout 1985. The fact that the monthly

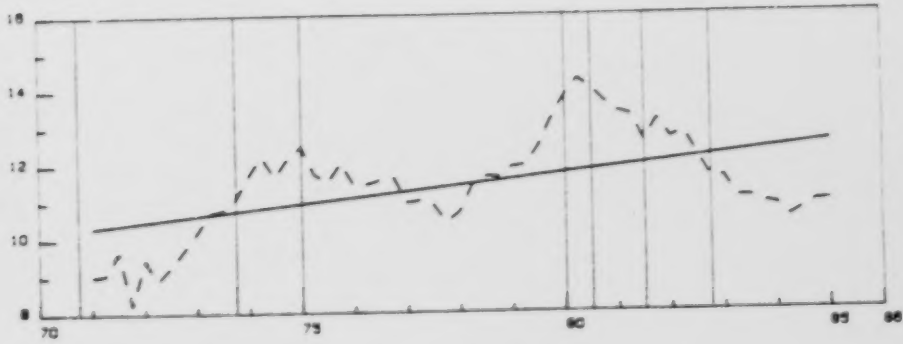
7. An analysis prepared by CBO at the request of Senator Lawton Chiles, Committee on the Budget, United States Senate, March 30, 1984, and a paper "A Forecasting Model for the U.S. Merchandise Trade Balance", by William Helkie, presented at the Fifth International Symposium on Forecasting, Montreal, Canada, June 9-12, 1985.

Figure 14.

Real Merchandise Imports as a Percentage of Real Domestic Demand for Goods



Real Merchandise Exports as a Percentage of Real Goods Output



SOURCE U.S. Department of Commerce, Bureau of Economic Analysis, Congressional Budget Office

trade deficit in May was the second largest ever recorded, even while domestic growth was moderated, is evidence of the importance of the lagged effect of the decline in price competitiveness induced by the appreciation of the dollar. Combining the influences of the continuing expansion in the trade deficit with the moderation in the GNP growth rate in the last two to three quarters, the goods share began to decline in the last part of 1984, and is likely to continue throughout 1985, probably at below cyclically adjusted levels.

Relative Effects Across Detailed Industries

Even though goods output has maintained its cyclically adjusted share of GNP, this masks important shifts in the relative output shares of more detailed goods producing industries. In general, sectors most sensitive to cyclical demand movements, and those sectors that benefit directly from increases in defense spending and reductions in investment tax rates were likely to fare well in recent years. Industries experiencing significant foreign competition, in both domestic and foreign markets, tended to lose. There is some overlap between these two influences, but an inspection of the share of output of more detailed sectors to total real goods output shows that electrical and nonelectrical machinery and transport machinery clearly gained shares during the 1983-1984 recovery, while primary metals, textiles,

apparel, leather products, and miscellaneous manufacturing clearly lost shares. ^{8/}

Note that the gainers tend to be most closely related to fiscal policy incentives favoring defense and investment goods, while the losers are predominantly those sectors that have been losing domestic output share for the last 10 to 20 years, largely as a result of fundamental disadvantages they have in competing with foreign producers. These disadvantages remain present throughout various stages of domestic business cycles and exchange rate fluctuations.

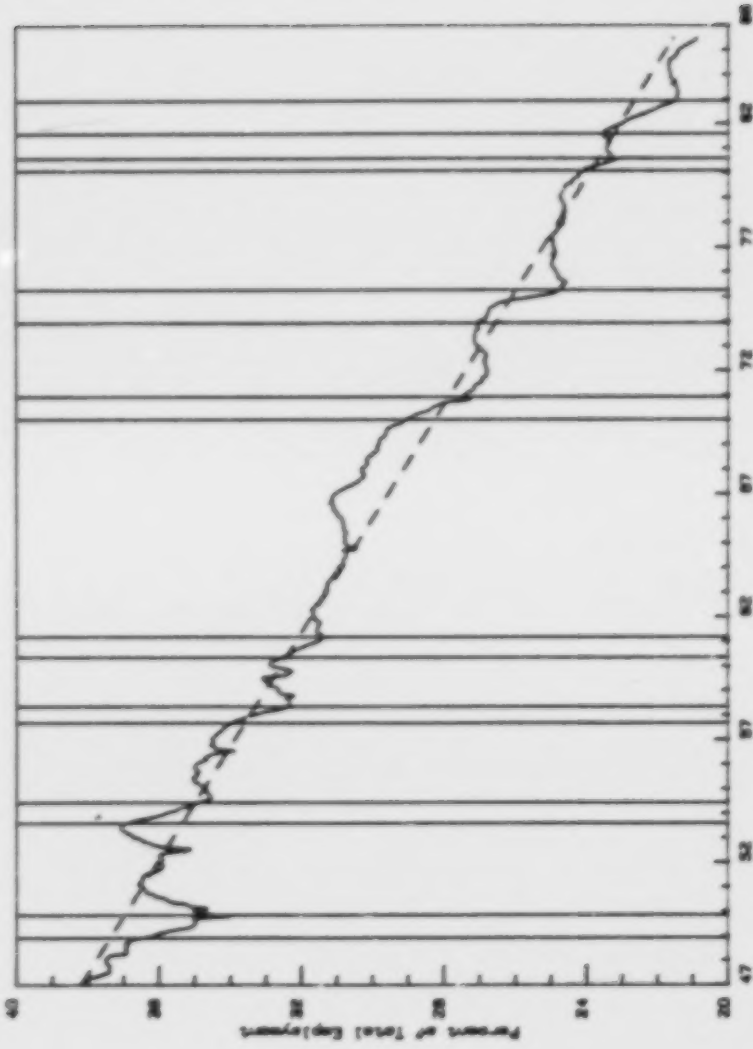
Compositional Shifts in Employment

Employment in goods producing sectors relative to other sectors has been affected more than has output. Although the proportion of employment in goods producing sectors to total payroll employment rebounded on trend with the recovery from the 1982 recession, its share abruptly leveled and declined in mid-1984 and has continued to drop. Since the beginning of 1985, there has been no growth at all in goods employment, and manufacturing employment has fallen by 222,000. This decline in the relative share of goods employment appears to be below the normal trend level for the middle stage of a business recovery (see Figure 15).

The decline in the share of employment in the goods producing sector in the face of a high share of goods in total output is the result of higher

8. Note that in 1985, electrical equipment appeared to lose its share by an amount greater than would have been predicted by cyclical movements.

Figure 15.
Share of Goods Producing Sector to Total Payroll Employment



SOURCE U.S. Bureau of Labor Statistics, U.S. Department of Labor

NOTE Includes manufacturing and mining

productivity growth in the goods sector than in the economy as a whole. In fact, while manufacturing productivity is currently approximately on its postwar trend, productivity in the nonfarm business sector as a whole is well below trend, and has been so since about 1979. Reasons for changes in productivity growth are not well understood, but many analysts would point to the two recessions of the 1980s, and the oil price increases of 1974-1979, as major factors in the sluggish performance of overall productivity since the late 1970s. Manufacturing does not seem to have shared in the overall weakness of productivity growth. Some think this may be in part because foreign competition in the manufacturing sector has forced more stringent cost-cutting measures than in the rest of the economy, though there are no empirical studies supporting this hypothesis. Recorded changes in productivity are also heavily affected by shifts of output between industries that are more or less labor intensive, and do not necessarily reflect any change in productivity in particular plants.

Declines in employment shares of several detailed sectors have been especially pronounced. Some industries, such as steel, textiles and apparel, and leather products, have lower employment levels in mid-1985 than at the trough of the 1982 recession. Table 3 shows changes in employment from June 1984 to June 1985. Of particular note is the low employment growth in goods industries relative to services and construction, and the large declines in employment in primary metals, textiles, apparel leather, and refined petroleum and coal products. Employment growth in the manufacturing of

TABLE 3. PERCENT GROWTH IN EMPLOYMENT (June 1984 to June 1985)

Sector	Percent Growth
Total	3.4
Goods Producing	1.0
Mining	-0.1
Construction	7.1
Manufacturing	-0.3
Durable	0.1
Lumber	-2.1
Furniture	1.2
Stone, clay, glass	0.5
Primary metals	-6.0
Fabricated metals	0.6
Machinery, except electric	-0.7
Electrical and electronic equipment	-0.1
Transportation equipment	4.3
Instruments	1.2
Miscellaneous manufacturing	-1.5
Nondurable	-0.9
Food	1.5
Tobacco	1.8
Textile mill products	-7.0
Apparel	-4.7
Paper	0.1
Printing and publishing	3.4
Chemicals	-0.8
Petroleum and coal	-4.0
Rubber	0.9
Leather	-11.2
Service Producing	4.2
Transportation, public utilities	3.0
Wholesale trade	4.2
Retail trade	5.5
Finance, insurance, real estate	4.1
Services	5.7
Government	1.3

SOURCE: Bureau of Labor Statistics, U.S. Department of Labor.

durable goods stayed about constant, while employment in the manufacturing of non-durable goods declined by almost one percent.

POLICY CONSIDERATIONS

CBO's analysis suggests that the current value of the dollar is to a very large extent determined by the magnitude of U.S. budgetary deficits and a concomitant demand for foreign capital by the United States.

On the other hand, even with a balanced federal budget, the competing uses for capital worldwide imply that net international capital flows may persist over very long periods of time and may in fact be entirely appropriate. Such a situation would imply the persistence of current account surpluses and deficits among all of our trading partners. Indeed, for much of the 20th century the United States has been a net supplier of capital to the rest of the world. It may also be appropriate for the United States to be a capital importer for brief periods if those resources are invested in productive investments as opposed to being used to finance public deficits.

Furthermore, because bilateral trade is the result of comparative advantages of the different international traders, it is almost certainly true that our trade balance with some individual countries will always be in surplus or deficit even if all countries were simultaneously in current account balance in their overall trading relationships.

The discussion above suggests that to a large extent the source of our trade problems can be traced to our own fiscal policies. This does not mean

that we should not continue to press vigorously for freer access of U.S. exports to foreign markets. The discussion above does suggest, however, that our trade problem will not be solved by imposing restrictions on imports of goods, services, or capital. Such restriction would only reduce the efficiency of the economy without causing a major reduction in the trade deficit. ^{9/}

Without action, the absolute size of the federal budget deficit is likely to get worse. CBO's baseline projections of last February had federal deficits in nominal terms rising through the end of the decade and approximating \$300 billion by 1990--over \$100 billion more than in the last fiscal year. With such a widening of the fiscal deficit, further deterioration in the current account is exceedingly likely. It is therefore imperative to reduce the federal budget deficit in order to reduce the likelihood of further increases in our trade and current account deficits.

The magnitudes of budget deficit reductions implied by the separate budget resolutions adopted by the House and the Senate would noticeably reduce the pace of federal debt accumulation relative to private wealth and therefore reduce the upward pressure on real interest rates. In the absence of other strongly offsetting influences, the dollar should depreciate in real

9. The economic consequences of an import surcharge are discussed in detail in my statement on this subject before the Committee on Finance, U.S. Senate, April 24, 1985.

terms against other currencies. In time, such depreciation will help to halt deterioration in our external accounts. One should, however, be aware that, even with a significant turnaround in the value of the dollar, improvements in our external accounts will not be immediate.

It usually takes several years for the full effects of a change in the exchange rate to work their way through prices and volumes of traded goods, as well as through the domestic sectors of the economy affected by trade. Moreover, since exchange rate changes affect import prices fairly rapidly relative to export prices, the value of imports may initially increase more than exports improve or import volumes decrease. The result would be a short-lived worsening of the nominal trade balance along with a weak improvement in the real trade balance. Over time, import volumes decline and export volumes and prices increase sufficiently in response to the depreciation to produce the expected improvement in the trade balances. 10/

-
10. The above observations concerning the timing of nominal and real trade balance responses to exchange rate depreciation assume that future actions mimic past behavior. Some observers have predicted that the near-term response of U.S. trade balances to a gradual dollar decline of moderate proportions may have little impact on trade volumes in today's economic environment, as profit margins are adjusted to maintain relative prices and market shares. This profit margin flexibility originates from the strong dollar appreciation since mid-1980 and is likely to be stronger on the import side, where profit margins have been inflated by the strong dollar, than on the export side, where profit margins have been squeezed. To the degree that this occurs in a more radical fashion than in the past, the impact of a depreciation will have less effect on real net trade flows than observed previously. In fact, several analysts expect that it will have almost no effect on import volumes.

CONCLUSION

A combination of many different factors has caused unprecedented deterioration of U.S. international trade position. Among these factors, it is my judgement that huge federal budget deficits bear the main responsibility for drawing into the United States very large amounts of foreign capital, and for the associated phenomena of dollar appreciation and increased current account deficits. The dollar appreciation and record trade deficit have not tended to have significant impacts on the share of domestic goods production relative to total GNP. It has caused, however, important shifts in output shares of more detailed sectors, resulting in an uneven distribution of adjustment across sectors to the trade deficit. While the share of goods output has proved to be quite resilient, the share of employment in goods producing sectors appear to have declined below trend-adjusted levels.

Reducing future budget deficits does not guarantee a commensurate reduction in future current account deficits. Other factors exerting influence on our external position may temporarily offset the beneficial effects of federal deficit reductions on our current account balance. At any rate, the improvement in our international account will not be immediate. Without decisive action on the budget deficit, however, it is highly likely that our trade and current account deficits will continue to deteriorate from their present levels.

Chairman LAFALCE. Thank you, Mr. Penner.
Dr. Kubarych.

**STATEMENT OF ROGER M. KUBARYCH, VICE PRESIDENT AND
CHIEF ECONOMIST, THE CONFERENCE BOARD**

Mr. KUBARYCH. Thank you very much. I am not as experienced in congressional testimony as my colleagues, and so there is more than a little sense of exhilaration. I am even less experienced at summarizing so adequately as these two gentlemen have done, but I will try.

The policy debate that is going on, Mr. Chairman, over the interconnected issues is oftentimes confusing, and what strikes me is how sharply conflicting some of the policy advice has been, either the sense of alarm on one side in favor of doing something very urgently, while on the other side looking at the same data and not seeing a reason for dismay or any specific policy responses.

My own view is that we are on a very risky course. We are sooner or later going to wish we had not pursued this course, because the adjustments will be more painful later on. But we are not going to have a sudden shock, sudden panic in financial markets, I don't believe. This is more like a cancerous situation, a slow growing cancer, than it is like a heart attack or stroke.

So we will be faced with thinking about the issue of debt, exchange rates and deficits for some time to come.

The question I am usually asked is whether the deficits are financeable indefinitely, or will there be a sudden break? The answer is a logical one: We cannot have deficits if they cannot be financed; the one entails the other. The interesting questions are at what interest rate levels and exchange rates they will be financed, and who will do the financing?

We ought to be able to find out who is financing the deficit more precisely than we can. In fact, when you look at the data—and I have some summary statistics in the testimony—you see there is a very large item called errors and omissions. We do not know fully and completely how and by whom the deficits are being financed, and it is important to know this because everybody has different incentives and different constraints operating in what kinds of U.S. assets they buy.

Most of the financing has come through the banking system, reflecting relative credit demands primarily, or through the bond market. There has been some considerable amount of direct investment by foreign companies, those wanting to operate here, but very little activity in the stock market.

In short, it is mostly debt rather than equity.

The only thing economists can say with any certainty is that the more and more dollar assets that foreigners acquire in their portfolios, the fussier they will become in terms of buying more dollar assets, and the more sensitive interest rate levels become to their overall motivation for acquiring our assets.

How did we get into this situation? It is amazing how much people concentrate so much on what is going on in this country when looking at the dollar. For every currency relationship, there

are two countries, and it is every bit as important what is going on abroad.

When you look abroad, you see a severe crisis in the debt positions of a lot of Latin American and other countries. That costs our exports dearly. I have seen estimates of \$75 billion of lost exports cumulatively since the debt crisis hit. That is a very major impact.

In addition, the slow growth in Europe has a direct and indirect effect on trade, and on enthusiasm for foreigners to buy our assets. There are very profitable European companies who are expanding their exports worldwide. Their own markets at home have been weak. They look here for assets which they think are high yielding, easily marketable and safe. This relative growth pattern has had a major effect on their decisions about where to put money. That has kept the dollar higher and has exacerbated problems for U.S. industry.

A further point to remember is how unique our experience has been. Other countries run large government deficits but they are not ordinarily associated with strong currencies. Big deficits do not usually entail enthusiasm on the part of foreigners to put money in such countries. Quite the opposite, their currencies usually weaken.

So what makes us so different? There is no one answer, but it has to do with an overall evaluation of the direction of economic developments—particularly the more pro-business attitude embodied in the tax changes of recent years and also among the general public. Most foreign investors I talk to stress this above all other factors as a major source of comfort in making these large-scale investments here.

They really do believe that we are embarked on a pro-business, pro-growth, pro-productivity experiment. So in a way, they are more confident about the United States than a lot of U.S. investors are.

Now, I think that they also cite three very important, more policy-relevant themes, too. One, they do cite the fact that the Federal Reserve will not give in, will not monetize the deficits, will avoid lurching in one direction or the other, and will not touch off renewed inflation.

Second, they do believe that the tax cuts for business had bipartisan support, so there will be more permanence to that.

Parenthetically, I might say that the decline in the dollar in recent weeks (and it has added up to something fairly meaningful now, not perhaps as much as some industries would like to see but it is starting to add up) this coincides with the debate over the tax reform proposals in which some business tax cuts are whittled away or offset. I think foreign investors are concerned about that.

If the Federal Government deficits were primarily caused by more Government spending rather than by tax cuts, I don't think you would see the same kind of enthusiasm by foreign investors for our assets.

Finally, every foreign investor I speak to believes that the United States will solve the deficit problem. They just believe it is a matter of time before the consensus is reached and compromises are made.

Now, to wrap up, there are some other important dimensions to capital movements into this country that have very little to do

with policy considerations in this broadest sense but really have to do with the way businessmen behave abroad.

To begin with, there is a very decisive long-term strategy among foreign exporters, primarily in the newly industrialized countries of Asia, to improve their market share here. They are going to pursue this strategy more or less regardless of what happens to relative exchange rates.

We have to expect that there are forces leading to high imports in the country that have very little to do with the actual course of relative interest rates and exchange rates, basically having to do with where the most open market is for these products. That has apparently been the United States according to these businessmen.

Next, the fact that you have a Government deficit does not mean that you have to have a trade deficit. Japan is the best example of that.

This identifies the key problem as the one that you, Mr. Chairman, mentioned in your opening statement: a savings problem, rather than primarily a trade problem per se. And the Japanese have a savings problem of their own, every bit as big as ours.

Their savings problem is an overabundance of savings, which is causing quite a lot of friction in world trade for them. And we have an inadequacy of savings that is causing us large deficits both at the Government level and at the trade level.

Mr. Chairman, I don't think there is any single action that will cure all of these imbalances at once. Obviously, the first step has to be cutting the budget deficit. Yet, it would be wrong to expect that this single action would immediately change the course of the trade deficit. There is good reason for believing that even if we did what we need to do on the budget deficit domestically, it would take quite some time to make a meaningful change in the trade position.

The budget deficit action would in fact have enormous appeal to Wall Street. It would certainly be viewed as the United States dealing with its single most important problem. Thus, it would lead to a rally in the stock market. The bond market would also rally. Foreigners would want to get in on those rallies, and for a temporary period, at least, the dollar would be just as strong or maybe stronger. That combination of factors would prolong the trade deficit even after the budget deficit was addressed.

The one key element that has to be handled in tandem is to get better growth and profitability growing in Europe so that foreign investors have more choice, a more balanced set of choices of where to make investments. It is under those circumstances that we can have both continued reasonable growth in this country, a better balanced dollar, and an improvement in trade deficit at the same time.

Thank you.

[The prepared statement of Mr. Kubarych follows:]

STATEMENT BY

ROGER M. KUBARYCH
Vice President and Chief Economist
The Conference Board

before the

SUBCOMMITTEE ON ECONOMIC STABILIZATION

of the

COMMITTEE ON BANKING, FINANCE, and URBAN AFFAIRS

U. S. House of Representatives

July 18, 1985

Mr. Chairman and members of the Subcommittee, I am pleased to respond to your invitation to discuss the complex subject of "U.S. Debt and the Dollar."

Both in the media and among professional economists, there seems to be a certain amount of confusion about the relationships between the U.S. federal budget deficit, our trade deficit with the rest of the world, our shift from a net creditor to a net debtor nation, and the value of the dollar in the foreign exchange markets. What's even more striking is the range of views about how seriously you in the Congress should be concerned about the unprecedented situation we find ourselves in. Some express alarm and call for urgent action, but others look at the same data and see no reason either for dismay or for a specific policy response.

In a nutshell, my own view is that we are embarked on a highly risky experiment. Sooner or later we are going to look back and wish that we had not proceeded on a course so riddled with imbalances and so unfair to large segments of industry, their employees, and their communities. And the longer we go on with this bizarre combination of towering federal deficits and

continuing massive needs for foreign savings to supplement our insufficient domestic savings, then the greater and more painful the eventual adjustments will need to be. But in saying this, I am not predicting an abrupt crisis or outright panic on the part of investors, local or foreign. I am only asserting that the kind of economic performance we all seek--healthy growth that provides its benefits fairly across industries and to all segments of society, together with low inflation--will be substantially harder to achieve over any reasonable time horizon.

To get to the heart of the analysis, I want to identify a handful of points that are important to bear in mind when thinking about the connections between the domestic economy, the external sector, our financial markets, and the foreign exchange markets.

The question that comes up most often is whether these deficits can be financed indefinitely. As a matter of simple logic, the answer must be yes, because if you can't finance a deficit, trade or budgetary, you can't run it in the first place. The valid, interesting, but far more difficult question is how a deficit will be financed--by whom, at what relative interest rates, and at what exchange rates.

The "by whom" question ought to be straightforward to answer, but isn't because the data are hopelessly incomplete. (See accompanying table for a summary of the main statistics.) We know that a quarter to a half of the recent U.S. current account deficit (the broadest measure of our trade in goods and services with the rest of the world) has been financed through the banking system. Put simply, when banks located here try to meet the credit demands of their domestic customers, they look to the international money markets as a source of funding. Those markets are where foreign investors normally choose to place their short-term assets. Thus, when domestic credit

markets are relatively taut and international markets relatively liquid, funds flow into this country. In the process, that helps finance a current account deficit, whether or not the actual credits extended by the banks are specifically related to foreign trade.

The U.S. Current Account and Its Financing

<u>\$Billions</u>	<u>1983</u>	<u>1984</u>	<u>1985I</u>
Current Account	-40.8	-101.5	-30.0
<u>Financed by:</u>			
Net bank flow	19.4	23.2	12.7
Net other private capital flow	3.7	40.9	9.7
Net direct investment	6.6	18.0	3.3
Errors & omissions	11.5	24.7	16.7
Foreign official flows	- 0.4	- 5.2	-12.4

The other half reflects a mix of activities. U.S. companies borrow abroad and repatriate the proceeds. Foreign investors buy U.S. money market instruments, bonds, stocks, real estate and other property. These transactions show up in "other private capital flows." Foreign corporations set up or expand affiliates here, which is termed "direct investment." Of course, U.S. residents do all these things, too, in other countries, so it's the net flow that matters for each category. In this context, moreover, it is just as important when a U.S. citizen sells, for instance, a Dutch bond he's owned as for a Dutch citizen to buy a U.S. bond. While tempting, it is wrong to try to oversimplify the complexity of a country's balance sheet, because each group responds to different incentives and faces unique constraints.

Similarly, we ought to recognize that the terms "net creditor" and "net debtor" are really pretty fuzzy. They amalgamate a spectrum of various kinds of assets with different yields and risk profiles--not all debt, not all equity. And those terms, "net creditor" and "net debtor" have little or no predictive power with regard to exchange rates. For example, the United States was a big net creditor nation in the 1970's when the dollar was generally falling. Japan was still a net debtor country during that time when the yen was generally rising.

All that economists can assert with some confidence is that the more dollar assets investors hold in their portfolios, the more selective they become at the margin in terms of acquiring more of the same. That means that eventually it will take higher and higher yields to attract new investments, other things equal. But no one knows when that would translate into serious upward pressures on U.S. interest rates. It hasn't so far. And other things never stay equal; all kinds of factors influencing yield expectations and risk calculations also come into play. The frequency of the shifts in investor judgements may account for the reason that the econometricians in the profession have been thoroughly confounded in trying to build statistical models to predict either international capital flows or exchange rates. There is too much happening, and it is continually changing.

The second most frequently-asked question is how the U.S. got into the current situation. Admittedly, our large budget and trade deficits are home-made to a large degree. But they also are a by-product of economic forces originating in the rest of the world. Too often, for instance, people analyze the reason for the strong dollar solely in terms of the United States and overlook the fact that, for every exchange rate, there are two countries. So, it's important to look at what's going on in other countries, as well.

Specifically, the debt crisis in Latin America and elsewhere has sharply reduced U.S. exports--perhaps by as much as \$75 billion. Thus, those problems have had a severe effect on many U.S. industries which had built a good business supplying Latin American markets with capital equipment, instruments, and other advanced products. Those sales could not be readily replaced in other foreign markets. The result has been a difficult adjustment period, with lower U.S. output, employment, and profits in many industries than would otherwise have occurred.

Similarly, the failure of most European countries to achieve tolerable economic growth rates, fast enough to lower their high unemployment rates significantly, has been a source of strain. In Europe, low demand has meant unsatisfactory profits and weak incentives for investment. Instead, European industrial companies and other investors have looked to our markets to establish or expand their facilities here or simply to acquire what they have considered to be high-yielding, easily marketable, safe financial assets. That has been a key factor undergirding the dollar throughout the past three years or so.

Moreover, weak overall demand in Europe has meant poor levels of imports. To some extent, that has directly compounded the problem of U.S. exporters struggling to compete with the handicap of a super-strong dollar. But what's worse, low import growth in Europe has retarded the progress of debt-troubled nations toward exporting their way out of their debt difficulties. And that indirectly curbs U.S. export potential, because under today's strained circumstances, the only way countries like Mexico, Brazil, Chile, Argentina, Peru, the Philippines, and others can greatly expand their own imports is by first expanding exports.

In short, disappointing economic performance in Europe, combined with constrained economic activity in Latin America and other places, and deep-seated political uncertainties, has had profound consequences. That combination has stimulated foreign investment in the United States, kept the dollar high, and directly and indirectly worsened our trade position.

A second point to bear in mind is how unique the U.S. debt experience has been. For one thing, large government deficits are not ordinarily associated with a strong currency. Usually, foreign investors shun countries where deficits are large and expanding. Their currencies get weaker, or else the government tries to prop up the currency artificially, either by spending its official reserves or by putting on exchange controls. The recent example of France is a case in point. There are many other examples in both industrial and developing countries.

Why has the United States been so patently different? There is no simple reason, but it is clear that a number of features of the U.S. economic situation lately, apart from the budget deficit, have appealed to foreign investors. They admire our citizens' ability to start new businesses. They like the entrepreneurial pockets to be found in our largest companies. They believe that there has been a swing in public sentiment in favor of business. Bright young minds are being attracted to business, rather than to the civil service. Abroad, it's often the other way around. Foreign investors are mightily impressed by the vast improvement in labor-management relations that has occurred, and feel that performance-based wage bargaining, strongly influenced by a firm's own productivity and profit experience, is an important trend in U.S. industry, becoming more firmly established all the time. Thus, they are less worried that the wage-price spiral which plagued us in the 1970's will reemerge any time soon.

However, three additional ingredients have been indispensable, in my view, ^{making} in foreign investors willing to tolerate or even ignore the huge federal budget deficits when framing their investment strategies.

One, there is a widespread belief that the Federal Reserve will not give in to familiar pressures^o to lurch toward excessive stimulus whenever economic activity temporarily slows. Put another way, foreign investors do not believe the Fed will monetize the government deficits and touch off another acceleration in inflation.

Two, many foreign investors like certain aspects of the policy shifts that essentially made large deficits inevitable, especially the cuts in business taxation. They judged that the tax initiatives had bipartisan support--indeed much of the thinking on accelerated cost recovery and on more lucrative investment tax credits had its origin in previous Administrations and within the Congress. Thus, foreign investors felt the changes signified a broader consensus in favor of increased business investment as the driving force for growth. All the better to invest in such a country, even if the investments initially take the form primarily of placements in bonds or short-term bank certificates, rather than shares of stock. Why? Because of the overall reduction in political/economic risk involved. (Parenthetically, it ought to be instructive that the recent slide in the dollar has coincided with suggestions that the consensus may be breaking apart with the unveiling of a major tax reform initiative that undoes many of the benefits of the existing law.)

In sum, if the massive budget deficits we are running were mainly the product of larger government spending, I doubt foreign investors would have had as much enthusiasm for putting their money in dollar assets as they have shown. But tax cutting has multiple constituencies!

Three, many foreign investors view the U.S. budget deficit, though admittedly gigantic, as well within the ability of the United States to solve on its own. They readily admit that our political decision-making process is unwieldy, overpublicized, overlobbied, and slow. But they feel that it is not terribly ideological, compared to most every other country where they might choose to invest, and they take for granted that compromises eventually get made. That optimism may have been tarnished a little recently, amidst the confusion over what has or hasn't been agreed with respect to the Fiscal 1986 deficit. Along with the new uncertainty over the tax system, that sense of mild disappointment might have also contributed to the decline of the dollar. But by and large, foreigners have faith--more than a lot of domestic investors--that our act will be gotten together one of these days.

Let me move on^{to} cite a few more specific propositions about the nature of this remarkable influx of foreign funds that has allowed us to finance gaping trade and current account deficits, plus a big government deficit, without starving everyone else in the economy for credit.

To begin with, an important motive for inflows from abroad has nothing much to do with budget deficits, differential tax systems, relative interest rates, or general policy concerns. It has to do with the behavior of foreign businesses, which have bigger fish to fry. They are the exporters, often Asian though not exclusively, who are embarked on a long-term strategy of increasing their market penetration for manufactured products. They find the United States the most open, vibrant place to sell, and highly profitable. They are willing to do what's necessary to build their market shares. That includes arranging the financing, either directly or indirectly through their banking associates, when that moves the merchandise. For purposes of our discussion today, what it means is that a key source of financing for our trade and

current account is incidental to the main determining force--which is the behavior of foreign exporters in a world where Europe, Japan, and a whole host of other countries are tougher markets to sell in than an expanding U.S. economy. It will take a major shift both in ~~the~~ relative growth rates around the world and in trading practices to upset this ^{syndiotic} ~~symbiotic~~ relationship between U.S. consumers and foreign producers.

Next, just because a country has a large government deficit does not necessarily mean that it will have a trade or current account deficit. Best example: Japan. Why not? Because the savings of the household sector and the business sector can add up to a greater amount than the government's deficit--and that excess savings of the private sector will show up as a current account surplus, as in Japan today. Two conclusions stand out. The first is that the U.S. problem is as much a savings problem as a budget or trade problem, which doesn't make it any easier to solve today or tomorrow but which does offer some hope in the next decade when the baby boom will reach middle-age, the prime savings years.

The second is that no great moral virtue should be attached to a set of economic policies and circumstances that generates excessive savings and overly large trade and current account surpluses. Both kinds of imbalances, deficits and surpluses alike, are ultimately disruptive to a framework of liberal world trade and open markets. Both require adjustments. That principle of symmetry has been embodied in the code of conduct of the International Monetary Fund, but people tend to forget that. Perhaps, it is instinctive to take pride in a trade surplus and to value providing savings to others, when most countries are in the opposite position. But deficit countries, as a group, can't adjust unless surplus countries do, too. That logic is unassailable, regardless of what instinct may say.

The special case of Japan is particularly relevant now, because there has been a lot of nastiness in the air lately about our bilateral trading relationship and great criticism of Japanese trade practices.

Yes, Japanese businesses and government at all levels do tend to discriminate against foreign products, and that must change--but not to slim the bilateral deficit with the United States. In fact, greater access to Japanese markets will not, given the present structure of exchange rates, do a lot directly for U.S. exports. It would, however, do wonders for the developing countries, those nations which will largely buy more U.S. goods once they are able to earn more foreign exchange.

Yet, opening up Japanese markets to more imports will not by itself radically alter either Japan's savings imbalance or the trade imbalance which results, unless and until there are major changes in Japanese internal policies and practices. In a sentence, Japan unduly subsidizes savings, which it has too much of, and constricts household spending (especially for better housing)--through the tax system, through regulation, and through custom. Gradually, that needs to change. And, besides eliminating explicit tax breaks for savings, one of the most important changes must be to open up the domestic consumer credit market to the same degree of competitiveness as Japan already has successfully done for the wholesale credit markets and the international markets. Why is it important? Because a lot of personal expenditures on consumer durables, particularly, depends on credit availability at reasonable cost. That is not not the case throughout Japan today.

The relevance of all this to the issue of the dollar and U.S. debt is crucial. The counterpart of the Japanese current account surplus is heavy investment in U.S. securities and other dollar assets. But, that outflow isn't philanthropy. Japanese investors aren't doing favors for people. They are

responding to their own sophisticated calculations about where the best place is to invest. The motivations are straightforward: yield, safety, and long-term diversification, especially on the part of institutions like Japanese insurance companies which for too long were excluded from world financial markets. In my judgment, we would all be better off with joint efforts to reduce imbalances--on our side, the budget and trade deficits, which means addressing the problem of insufficient savings, on the Japanese side the huge trade surplus, which means addressing the problem of savings subsidies and learning how to encourage greater investment in housing. But in the meantime, the single largest source of foreign capital to augment our savings pool will almost certainly be Japanese investors. So, it's important to understand objectively and rationally their own unique circumstances and perspective.

Finally, do not expect any single action--even one as critical to the future health of the world economy as the reduction of the U.S. federal government budget deficit--to be a panacea, at least instantly. Some may be rudely surprised by a seemingly perverse initial reaction in the foreign exchange markets. Just think of how Wall St. would respond if the budget deficit were cut by \$50 billion or, better, by \$75 billion. There'd be a rally on the stock market. Bond prices would be bid higher because a huge potential inflation threat would have been eliminated and dealers would correctly conclude that the Federal Reserve would have gotten huge latitude to ease monetary policy. All of this would be just as intoxicating to foreign investors, who would want to get in on both rallies right away. And they would bid up the dollar in the foreign exchange markets to do it.

The lower interest rates would, in the meantime, stimulate U.S. house-building, business investment, and state and local infrastructure construction. So domestic spending would stay firm, even without as much stimulus from the

federal deficit. Therefore, the trade deficit wouldn't change very much right away, because continued income growth would generate imports while the dollar's residual firmness would delay export expansion. Eventually, though, the lower interest rates would let (maybe compel) the authorities in other countries to bring down their own interest rates, their economies would grow faster, their imports would grow, and our exports would begin to improve. What's more, the developing countries would do better twice over--as the interest costs of their existing debt receded and as export markets strengthened. In turn, our exports to them would start to look a lot healthier.

Not a bad outcome, but not the best we can do. Better would be a coordinated program, anchored by a meaningful cut in our budget deficit (and all interested parties must give a little to let that happen), but buttressed with stimulative fiscal measures in Europe, including permanent business tax cuts and temporary consumer tax cuts, and an affirmative action program by Japan to raise their imports of manufactured products, especially from the developing countries. My guess is that this coordinated program would quite soon contribute to a more sensible configuration of exchange rates. That's mainly because yields on European currency assets would start to look more attractive and less risky, as those countries began to make more headway with their unemployment and industrial restructuring problems--always easier to do in an environment of growth than one of austerity and indecision.

In the end, the dollar would ease back to a level which would do far less damage than now to U.S. manufacturing (although some industries would face tough foreign competition because of differences in sheer efficiency). There would be less debt all around, more output, more jobs, more profits, more world trade and far better relationships among the countries of the free world. It's worth contemplating next to the gloomy scenarios, which others have already laid out for you, and which we must avoid.

Chairman LAFALCE. Thank you very much.

Let's go to the questions of the panelists now.

Governor Martin, I think both you and I have been concerned about the possibility of the United States at the very least entering into a growth recession. I think that where the GNP rises, but rises so slowly, that unemployment may well rise, too.

Now, this morning the Commerce Department has come out with a preliminary estimate of second-quarter growth and this preliminary estimate is 1.7 percent. That was after the first quarter rise of only three-tenths of 1 percent.

Are we in a growth recession? Is the fact that unemployment has not risen attributable primarily to the fact that our productivity growth rate has been declining over the past year or so?

To what extent is this growth recession leveling off the unemployment rate and potentially increasing the unemployment rate, and declining our productivity growth rate?

Is that attributable to the debt that we have, the dollar value, and especially to considerations in our trade and industries?

Mr. MARTIN. Well, Mr. Chairman, it seems to me that the second quarter data, if typical of those data, may undergo still further revisions. We don't know what the second quarter really has produced.

Chairman LAFALCE. First quarter data, when finally revised, was revised considerably downward.

Mr. MARTIN. Yes, sir.

Chairman LAFALCE. So the 1.7, if the past quarter was an example, might be optimistic.

Mr. MARTIN. Yes, but we have had four or five quarters of very sluggish growth in real terms and we have had a flat measure of unemployment.

So while we are not in what loosely is called a growth recession, we are certainly in a period of very sluggish growth, and I think a period of growth that is below this country's potential.

Chairman LAFALCE. How have our productivity growth rates been the past year or so?

Mr. MARTIN. The first 2 years of this recovery, we have had encouraging measurements of productivity.

Chairman LAFALCE. Which is what you usually have in a recovery.

Mr. MARTIN. Yes, indeed. Perhaps a little better than the last few recoveries.

Now, of course, the last couple quarters, the numbers have not been so encouraging. I think in that situation, the chairman is quite right in his allusions to some of the higher productivity areas, particularly manufacturing wherein there has been business investment, the so-called retrofitting of plants, computerization, telecommunications gadgetry installed, et cetera. Yet the impact of foreign competition with the strength of the dollar is such that those industries really can't get going.

On the other hand, the services, as we all know, have been the source for the added employment. These are not the areas in which most economists look for high rates of growth in productivity.

So certainly very recent productivity numbers are disappointing to me.

I have overestimated what productivity was going to be very recently. It can be attributed in great part to the structure of demand for domestic goods and services which is so strongly impacted by the foreign competition.

So I think, Mr. Chairman, that you in your statement have put the factors together.

Chairman LAFALCE. Thank you.

Would either Dr. Penner or Mr. Kubarych care to comment on that?

Mr. PENNER. I agree with that, with everything Governor Martin said. There is perhaps one ray of hope on the horizon, and I suspect that when we get better data and the Department of Commerce revises the GNP numbers, and in particular the price indices, that the history of the last few months will look a little different and a little better probably. The Department will be rebasing its price indices, and they will do a better job of accounting for the computerization of our society in those numbers, and so on.

I don't mean to imply, however, that they will look extremely good. I do think that the productivity movement is a concern and, like Governor Martin, I would really hope for a lot better in this recovery than we have gotten. If you take the measures as they exist today, we are below the average of the postwar expansions in terms of rate of productivity growth.

Chairman LAFALCE. That is a very serious problem for the long-term viability of our economy, particularly our manufacturing economy.

Mr. MARTIN. We are running way below the productivity growths of our trading partners, almost universally.

Mr. PENNER. And not unrelated is, of course, our abysmal savings rate, even if you just look at the private sector, forgetting—

Chairman LAFALCE. The 1981 tax bill didn't seem to do that much to help our savings rate at all, did it?

Mr. PENNER. It is hard to say. It is quite conceivable the savings rate would have gone down more without them. It is difficult for economists to sort that through. But, obviously, it didn't have an overwhelming effect.

Chairman LAFALCE. Mr. Kubarych.

Mr. KUBARYCH. You asked whether there was a growth recession, but in manufacturing, output is lower than it was 1 year ago actually, so they have had a mild recession in the manufacturing sector.

Manufacturing productivity is usually much stronger than the rest of the economy. That is shrinking. So it is no surprise that productivity will be very, very weak in that type of period.

It is very unlikely that you will see improved productivity until you get a better balance into the expansion with greater growth in the manufacturing sector. You are not going to see that any time soon because of the residual effect of the strong dollar.

Chairman LAFALCE. Go ahead.

On this question of productivity, isn't it true that in the early stages of a recovery, particularly when our industrial base was operating at a very low rate of capacity, that your productivity gains are going to be greater than that in the early stages and they are harder to achieve as you progress through the recovery.

Is that agreeable? Is that an accurate assessment?

Mr. MARTIN. I think that is an accurate assessment.

On the other hand, in industries that are bringing their output up to what management thinks is an optimal level of growth, of course, you can have in some instances productivity increase even in the later stages of the cycle.

Mr. McMILLAN. Isn't it true also that even now with the recovery we have had that we are still operating at a relatively low capacity ratio?

Mr. MARTIN. We are certainly, and other countries with whom we trade and developing countries are operating at very low capacity utilization levels, too.

And since we are a global economy, since this economy is so open to competition, their foreign capacity—Brazilian, German, Japanese, United Kingdom, etc—are all material now in looking at the growth potential for this country.

Chairman LAFALCE. The discussion seems to be focusing on productivity. I am glad for that.

When I first came to Congress, I started talking about productivity, and I don't think too many individuals had heard of the word. It was as if it were not a popular part of our jargon. Then it became a very important part of our jargon and almost became a buzz word.

I promoted it to such an extent that I was able to get a bill passed to establish a White House Conference on Productivity which was conducted in 1983. The President addressed the conference in September 1983, along with the Vice President, the Secretary of Treasury, etc. They were fulfilling the legislative mandate, but that's all.

I think you just have to do more than say we are going to have ACRS and ITC, and that is going to improve productivity, and leave it to the private sector. There must be some continuum and leadership.

I don't think this, or past administrations, have shown enough interest and leadership in enhancing the productivity of America's business.

In any event, let's go on to some other issues.

Dr. Penner, our deficit right now, as a percentage of GNP, is alarming to me not only because I think it is pretty high, but because I think it is pretty high at this point in the cycle in the experience of so-called recoveries over the past several years.

Can you give us any insights?

Mr. PENNER. You are speaking of our budget deficit?

Chairman LAFALCE. Yes.

Mr. PENNER. It is extraordinarily high on the unified budget basis, over 5 percent of the GNP and likely to stay that way.

In our projections of the current policies in effect last February, the unified budget deficit plus the off-budget stays a little over 5 percent right through the 1980's, reaching an absolute number of \$30 billion by 1990.

Chairman LAFALCE. That means it is a structural deficit, doesn't it?

Mr. PENNER. Very definitely, because those projections are based on a rate of economic growth that is somewhat greater than capacity growth in the economy, meaning that if you were actually—

Chairman LAFALCE. And it is very unlikely.

Mr. PENNER. I don't think so. We do have a lot of room in the economy, as we pointed out this morning, so I think over the longer haul it is reasonable to expect that you will have more than capacity growth. Nevertheless, what that implies is that at any given level of unemployment and excess capacity, that would increase as a percentage of GNP.

I would point out the various things that have changed since we made those projections on the other side. They were based on the defense path, for example, that the Congress voted last October, which was 5½ percent real.

I think it is clear that we will do better than that. We will do better on some of the nondefense discretionary programs and probably on medicare as well.

But, nevertheless, what kind of path we projected—

Chairman LAFALCE. What was our projected increase in GNP, for example, for this fiscal year as an economic assumption?

Mr. PENNER. We are running a little below capacity in terms of real growth. Actually, though, in terms of the nominal level of GNP, we are not very far off. Receipts are coming in about as planned and, in fact, there have been shortfalls in spending areas, particularly defense. So, it is not going to look too bad in the short run.

Chairman LAFALCE. Well, with a 1.7-percent increase in GNP, if that is accurate, what was the initial assumption before the 1.7?

Mr. PENNER. Let's see. Our forecast for the—

Chairman LAFALCE. For the year it was 4 percent, right?

Mr. PENNER. That was the administration's forecast. Ours was a little over 3 percent.

Chairman LAFALCE. All right, a little over 3.

When we come in at three-tenths of 1 percent, and if there is accuracy to the 1.7, isn't that going to affect the budget deficit, and isn't it going to be larger than you have forecast as a percentage of GNP?

Mr. PENNER. It pushes us in that direction. The shortfall at the moment has not been great enough to have a big impact on our estimates of the 1985 or 1986 budget deficit, but if it doesn't turn around soon, you are absolutely right.

Chairman LAFALCE. I am concerned for a number of reasons. But what does this do—the structural deficits that we have right now, which I think are in large part a combination of the increase in the defense budget and the 1981 tax cut—but what is it doing to our ability to resort to fiscal policy as a tool to deal with future recessions?

Mr. PENNER. I think it is pretty clear that fiscal policy is essentially impotent at the moment.

Chairman LAFALCE. In other words, you no longer will be able to resort to fiscal policy as a tool to deal with future recessions.

Mr. PENNER. Well, I think—

Chairman LAFALCE. If we did resort to it, it would be at our own peril.

Mr. PENNER. That is the point. Even if you did, when you start with deficits of this size, enlarging them further would scare financial markets and as a result the expectational effects may counter any Keynesian stimulative effect. Moreover, in the world we live in, with flexible exchange rates and international capital markets being perfect, you do get the offset on the trade side fairly quickly.

Chairman LAFALCE. That puts the ball in your court, Governor Martin, in combating what is going to be a reality at some point in time—the question is when—and that is a future recession.

If we are not going to be able to resort to fiscal policies because of the structural deficits, it is going to have to be a monetary policy, it seems to me. What will we do then?

Mr. MARTIN. Well, Mr. Chairman, you are quite correct; it puts additional pressure on the monetary policy side, going into a recession with a foreign debt service problem and starting from relatively high real interest rates. What we can do in a recession period is a classic central bank loosening of credit with the expectation of helping in bringing down interest rates. But, of course, that complicates the attraction of foreign capital as our rates come down, as we have seen in other countries like the United Kingdom, in which the interest rates relatively are very high. We are dealing in the monetary policy area with this additional factor of the substantial external position of the United States.

That doesn't say we don't concentrate on restimulating the economy and offsetting the negative impacts of a recession, but it is a complicating factor.

Chairman LAFALCE. I am just concerned that we have not yet seen the full effects of the structural deficit that we have created and that the full effects are going to be far graver than what we have envisioned, and could possibly be a wild inflationary period because of monetization of the debt that would have to be brought about if we were going to combat this huge recession.

Are my fears, if not fully justified, at least warranted?

Mr. MARTIN. Certainly, your fears are warranted. The situation would be much better if there were a mixture of fiscal and monetary policy changes, and better in the situation in which our continental economy is more of a closed economy, neither of which prevail, as I might add.

Mr. McMILLAN. We have been referring to the problem as one of a structural deficit. I would like to throw out the idea that the problem is not one of a structural deficit but one of a structural spending, and elicit your comments on that point, given the fact that the level of spending in the budget has moved from a range of about 20 percent of GNP to somewhere in excess of 25 percent in this year, and that that difference, regardless of how you account for the makeup of that spending, is what is creating the deficits.

We did pass a tax rate reduction bill back in 1981, but in terms of the percentage of gross national product, it represents revenue into the Federal Government. We were operating at pretty much all-time highs despite the structural changes in the tax laws in 1981 and thereafter.

Would you agree that our problem is essentially one of the level of spending?

Mr. PENNER. I think that you—

Mr. McMILLAN. As the primary cause.

Chairman LaFALCE. I would just disagree with the economic data that you presented, but I will leave it to the panelists to discuss the issue.

Mr. PENNER. I think it all depends on where you start in history. But it is true that our overall tax burden at the Federal level has seemed almost to be one of the divine constants of nature; that is to say, tax burdens today are very little different than they were in the late 1960's and it would take a pretty precise statistician to see a very significant uptrend in it. Maybe there has been a tiny uptrend in the tax burden, but not much.

On the other hand, spending has been on an upward trend and it has been on that trend for a good long time. Whether that is a problem or not, of course, depends solely on how you evaluate that spending, whether you think government is doing appropriate things or not.

I think my only point would be that if you think government is doing appropriate things, we just have to be prepared to pay for it in the tax burden. So, whether you define the problem as taxes being too low or spending being too high, I think it is—

Chairman LaFALCE. Isn't the fundamental problem a mismatch between spending and taxes?

You can quarrel endlessly as to whether or not the appropriate level of spending and taxing should be 18 percent, 19 percent, 20, 21, 23, 24, 25, or 40 percent of GNP, but it is the mismatch between them that has created the deficit problem, is it not?

Mr. PENNER. That is correct. I think the levels are truly an ideological question in the best sense of the word.

Chairman LaFALCE. If you start from the year 1980, you would find that the level of spending as the percentage of GNP and the level of spending today is approximately the same, is it not?

Mr. PENNER. No; the spending has gone up.

Chairman LaFALCE. Up about three-tenths of 1 percent of GNP, has it not, in that period of time?

Mr. McMILLAN. Five.

Mr. PENNER. Not enormously.

Chairman LaFALCE. Down 3 percent from 1981.

Mr. PENNER. In the unified budget for 1979, 20.8 percent of GNP; 1980, 22.4 percent.

Chairman LaFALCE. 1981?

Mr. PENNER. 22.8 percent, and then in—

Chairman LaFALCE. Fiscal 1981 was 22.8 percent. What is it this fiscal year?

Mr. PENNER. In 1985, 24.3 percent.

Chairman LaFALCE. Fiscal 1984?

Mr. PENNER. 1984, 23.5 percent.

Chairman LaFALCE. What about revenues?

Mr. PENNER. This fiscal year, 19.1 percent; in 1981, 20.8 percent. I would point out that it is 19.1 percent from 1974 as well, just as a matter of curiosity.

Mr. McMILLAN. If you took the moving average rather than pin-point years and measure the change, you are talking about over time, the expansion of that differential on the order of 4 to 5 percent of spending over revenues.

Mr. PENNER. That is right.

Mr. McMILLAN. Spending is rising and revenues basically remain constant as a percentage of GNP.

Mr. PENNER. Yes, sir.

Mr. McMILLAN. Hence, my argument, which you don't agree with, the problem is essentially one of an expanding level of spending, and you are right, it is an ideological question as to whether that is appropriate or not.

I would also like to followup with a question.

Let's say we ideologically accept the idea that that level of spending is appropriate. Then the only way to overcome the deficit is to raise taxes and if you raise taxes to offset that shortfall, is the economic impact of that better or worse than running a deficit and borrowing money in terms of short-term economic effects?

Mr. MARTIN. Of course, your increase in taxes will affect the GNP growth itself, and the structuring of that increase in taxes will have a real bearing on which sectors will see a diminution in growth, relative to a baseline in the absence of such tax changes. What are the growth factors, the multipliers and incentive effects coming from those major sectors?

We are caught in a dilemma that we are not paying our way. We are not paying our way domestically. We are not paying our way internationally, and we are storing up difficulties for our future whether it comes from the spending or taxing side.

Chairman LAFALCE. To make sure that I understand the facts, from 1981 to the present our expenditures have gone up by 1.5 percent as a percentage of GNP, and revenues have gone down by 1.7 percent as a percentage of GNP.

I am using the figures you gave me, Dr. Penner. Spending up by 1.5 percent, revenues down by 1.7 percent.

So the revenues going down by 1.7 are attributable to a good many different things, I think the tax cuts and recession, of course.

With expenditures going up, we were cutting domestic spending, almost all the increase in spending, that 1.5 percent, attributable to the increase in the level of defense spending?

Mr. PENNER. First of all—

Chairman LAFALCE. And debt expense.

Mr. PENNER. Yes, I was going to point out the debt expense, which is absolutely crucial in the result of these deficits. Let me also point out there was a little blip on the revenue side in 1981.

Chairman LAFALCE. I just want the figures accurately.

Mr. McMILLAN. I would think an accurate assessment of the problem, that is too short a term of trying to track the growth of spending and the declining revenue.

Chairman LAFALCE. You need a long-term and a short-term assessment to get an accurate evaluation, no question about that. But I think you have to look at both sides, spending and revenues.

Let's go on to monetary policy for a second.

Governor Martin, a number of critics of the Federal Reserve believe it has paid too much attention to the battle against inflation and too little attention to the rise in the value of the dollar and the injury that it has inflicted on the traded goods industries.

Do you think the Federal Reserve could do more to assist a decline in the dollar, gradually of course, and what would be the

impact on inflation under the present circumstances, if we attempted to assist it through monetary policy to bring about a decline in the dollar?

Chairman LAFALCE. And if we were able to do that, how likely would we be to see some type of improvement in our trade deficit?

Mr. MARTIN. We start from the situation in which monetary policy has been largely accommodative in recent quarters, one in which interest rates have come down on a 12-month basis, in some cases, 400 basis points, 450 basis points maybe.

So we have been in a period in which the central bank has been facilitating a market movement toward lower interest rates. We have been in a period in which the public's desire to hold liquid assets and money, and assets with moneyness, has shifted toward holding substantially larger balances and we have accommodated that desire on the part of the public to hold those balances.

We have moved in these directions with acute awareness of the indicators of inflation *ex post* and *ex ante*. *Ex post*, the fact is we are now in the fourth year or so—you can argue about that temporal extent here—of reasonably good results in inflation.

The wage settlements, union settlements, non-union settlements, price increases, even those in the service area have been tolerable. So this has given us the ability to accommodate both the demand for money and liquid assets on the one hand and a market in which interest rates, at least in a nominal sense, have come down.

Now, should we pay more attention to the dollar? There are alternatives, of course, that have to be weighed against domestic objectives.

Those who criticized us in that regard have said, "Why don't you, given the situation in inflation and the sectoral imbalances, simply increase the money supply a very substantial amount and bring down those short-term rates, which you know you can?"

Of course, our answer is that short-term rates are down; the long-term rates are down in many cases almost as much. And, therefore, we are talking about still further reductions in interest rates. We would all like to see rates down.

Chairman LAFALCE. Are the real rates down all that much?

Mr. MARTIN. The real rates are not down 400 points, but they are down some.

Chairman LAFALCE. Aren't they still quite high?

Mr. MARTIN. They are still very high from a historical perspective, yes, sir.

If you take 3.5 percent as the inflation rate and look at 9.5 or 10 percent charges on credit, you have real rates twice what our history would indicate is an equilibrium level, whatever that means anymore, so that we run the risk if we should greatly accelerate the providing of reserves to the banking system, that we can have the backing up of long-term rates, backing up from the forces of the market.

We cannot afford to lose our credibility with foreign investors, not at a time when we are not paying our way internationally and having to finance ourselves from foreign sources.

Therefore, monetary policy has to remain credible here and abroad. The risk of a massive move in providing reserves to the banking system and a much greater rate of growth of the monetary

aggregates and of debt than we already have, and they are high already, is that we lose that precious commodity of credibility, and that is a risk.

Chairman LAFALCE. You have noted on page 7 that with the continued strength of the dollar, there is some evidence of U.S. firms beginning to shift some of their production and investment abroad. Maybe there is evidence of this. I suspect it would happen at an accelerating pace.

If we had some type of analysis, I think it would be true that there would be overwhelming evidence of that fact. But yet, on Tuesday, Bob Ortner, chief economist at Commerce, expressed confidence in the rate of investment in the U.S. manufacturing sector.

I would ask any of you gentlemen, are you aware of the data on this? Are you pleased with the current and planned investment in U.S. manufacturing?

Mr. MARTIN. I think what Bob Ortner was trying to do was indicate there is a crisis in manufacturing. After all, investment plans in the manufacturing area are still positive. They are not as strong as they were in the early stages of the expansion, but they are still on the plus side.

Of course, the GNP figures still show some gains that can be attributed to the manufacturing area. It is a very slow progress. It is not what anybody would want but it is not in a crisis mode, as I read the tape accounts of Ortner's testimony.

Some of my colleagues may have a different view.

Mr. KUBARYCH. I brought along a recent report that we have done, Business Executive Expectations, that gives a mixed picture to your question.

We asked hundreds of businesses about their expectations for the economy and there is a very severe weakening that took place in the second quarter. Virtually all industries, even the ones that have been doing well, had a shift toward a weaker prognosis for the future.

However, on the question of reporting revisions of capital investment programs, there has not been a serious erosion in business planning in terms of their investment. And, in fact, the net result was no change, those plans for investment have been going forward.

Now, how do you reconcile those two things? One is that plans for investment may continue, but the actual pace at which they are made can be spread out. I think you see that happening.

There is an ability to retard investment projects, slow them down, space them over time. So you have that result.

Second, a lot of investment is defensive, survival investment, and it will go on, perhaps even at an expanding pace, the more pressure from foreign competition there is.

Simply, acceleration of competitive pressure leads to a certain degree of investment all by itself. So we have a mixed picture of severely eroded expectations about the future. Very few people in the business community are expecting real strength in the second half of this year. They would be surprised if the economy grew by more than 1 or 2 percent.

Chairman LAFALCE. How much investment are we having abroad by U.S. concerns because of the defensive investment taking place here?

Mr. MARTIN. I think you find that would be a mixed picture, Mr. Chairman, and that there are examples; Caterpillar and others can be cited as examples of investment abroad, shoe manufacturers, et cetera.

But there is a hesitancy on the part of the American manufacturer. He talks a lot about expansion overseas and he thinks, well, if I go to this country, there is this problem; if it go to that country, they tax this way, et cetera, et cetera. And there is some evidence it is beginning, but it could snowball of course.

Mr. PENNER. I think, Mr. Chairman, it is very important to differentiate between the location of the production and the location of the capital.

If you look at the direct investment abroad, we were disinvesting in the first quarter, according to the data I have here. But that doesn't mean you might not open new production facilities financed with capital drawn out of European capital markets, for example. I think that could be going on to a great extent.

Chairman LAFALCE. Is there any measurement of that?

Mr. PENNER. I don't have any.

Mr. KUBARYCH. It would actually be in the category "direct investment" when it is increasing. When there is an increase in capitalization by U.S. firms abroad, that would be the case.

Our investment abroad last year increased about \$1 billion. It was \$5 billion in 1983, net new direct investment abroad; it was about \$6 billion in 1984. These are not huge amounts.

Chairman LAFALCE. So the increase is roughly 20 percent in comparison to what type of increase or decrease in the United States.

Mr. KUBARYCH. Direct investment in this country has been very strong. It doubled. Foreign direct investment in the United States has been extremely strong. It is one of the manifestations of foreigners' enthusiasm about our economic situation. That went from \$11 billion in 1983 to \$22 billion.

Chairman LAFALCE. What have they invested in? Is it in liquid assets?

Mr. KUBARYCH. These are actual business enterprises, either expanding facilities that exist now; Volkswagen or Mazda setting up plants (that is in this category) or Nestles taking over Carnation, that is a direct investment as well.

It is a combination of expanding existing production facilities and taking over or merging with existing U.S. companies. It has been a major source of inflow into this country.

Chairman LAFALCE. Of the capital inflows, do we have any data as to what percentage has gone into banks here, into liquid assets as opposed to long-term direct investments?

Mr. KUBARYCH. If you look at the statistics on page 3 of my little handout, you will see that the net bank flow has been a substantial, and continuing, flow into the United States.

It shows the net direct investment which balances out our companies investing abroad with foreign companies investing here. It shows that the net bank flow accounts for a quarter to a half of

total inflows, and that net direct investment is also a very substantial inflow.

What it shows is a skewness of expectations about the U.S. economy. U.S. businesses and foreign businesses do have different views about what the outlook is like.

Chairman LAFALCE. Let me try to interpret page 3—perhaps you would do that for me.

The net bank flow is \$19 billion, then \$23 billion. What would the annual rate be? You show 12.7 percent.

Mr. KUBARYCH. Multiply by 4 and that would be the annual rate.

Chairman LAFALCE. That is over \$50 billion.

Mr. KUBARYCH. Yes.

Chairman LAFALCE. That is very large.

Mr. KUBARYCH. Very large in the first quarter, yes.

Chairman LAFALCE. And net other private capital flow—what do you mean by that?

Mr. KUBARYCH. That is an amalgam of all different securities and credit transactions and includes foreign purchases of U.S. bonds, government and private; includes U.S. corporations borrowing abroad and repatriating the funds; and it includes stock market—

Chairman LAFALCE. Those are pretty liquid then.

Mr. KUBARYCH. Pretty marketable, yes. They are not all liquid.

Chairman LAFALCE. So, we went from 3.7 in 1983 to 40—

Mr. KUBARYCH. That is when our bond market was improving and foreigners wanted to get in on the rally.

Chairman LAFALCE. Do we multiply 10 times 4?

Mr. KUBARYCH. Four times 9.7.

Chairman LAFALCE. Forty billion.

Mr. KUBARYCH. That is a substantial flow.

Chairman LAFALCE. Yes; but not much increase there.

Mr. KUBARYCH. Right. Of course, for the current account you have to multiply by 4, too. That is a \$120-billion deficit.

Chairman LAFALCE. The direct investment, \$6 billion, \$18 billion, then 4 times 3.

Mr. KUBARYCH. That tapered off.

Chairman LAFALCE. To \$12 or \$13 billion. That looks to me as if you don't have that much direct investment, then.

It seems to me as if the preponderance of your investment in the United States is in extremely liquid, marketable assets as opposed to net direct investment.

Mr. KUBARYCH. Compared to last year, that is correct.

Chairman LAFALCE. Compared to each other, compared to this yes, yes. What does that mean? What is the significance of that? Let's look at Continental Illinois Bank. How stable is this \$100-plus million of foreign investment in the United States? It could be withdrawn if there is some crisis or emergency. What would that mean to our economy or what would that mean to our financial institutions?

Mr. MARTIN. When you are talking about \$100 billion you are talking about the interbank market which is an enormous, electronically interconnected facility around the globe.

Those funds are moving daily and hourly. There is much talk of a 24-hour market. It is true there is a risk that foreign balances

can be—or at least some can be—withdrawn. Of course, when shifting very large amounts of money, the question is where will they be shifted? To the London market? It is difficult to shift to the Tokyo market except for the Japanese banks.

But, certainly, at the margin there can be some disorderliness injected into the markets by the shifting of funds. Which, of course, brings us into the category of the lender of last resort in these markets, and in the funding of our domestic institutions.

We have to be alert to these shifts and to the behavior of the markets here and abroad, and be ready to underwrite them in a sense if they become disorderly.

Mr. KUBARYCH. You are right, many of the marketable liquid assets could be mobilized to sell for another currency in a short period of time. So, if you are a foreign investor and you have a CD, you can sell the CD and buy German marks and put it with a German bank or buy German Government securities.

What is worse is that you can do the foreign exchange transaction even if you don't have assets here. If conditions and psychology change, if perceptions of Federal Reserve policy get upset, you can borrow the dollars and sell them. So, the actual pressure that can be mobilized in the foreign exchange markets over a short period of time is astronomical. That knowledge is always going to influence central banking views about the interrelationship between domestic monetary policy and the exchange market.

Chairman LAFALCE. What did you say was astronomical?

Mr. KUBARYCH. The amount of money you can mobilize to sell in the foreign exchange markets that you don't even have. You can sell dollars that you don't have simply by borrowing them.

Chairman LAFALCE. Does that mean the ability of the United States through its Fed and through other central banks to intervene in the markets to bring about some type of realignment of currencies is, what was your word?

Mr. KUBARYCH. Highly constrained.

Chairman LAFALCE. Highly constrained, all right.

Mr. KUBARYCH. Pretty weak.

Chairman LAFALCE. OK.

Mr. McMILLAN. As a point of reference, looking at your table on page 3, could you relate this to say aggregate net direct investment in the United States. What does \$18 billion in 1984 mean in terms of the total net investment for the United States?

Mr. KUBARYCH. Well, I think Rudy probably knows these numbers better than I do, but I can look at the table of—

Mr. PENNER. I have \$22.5 billion for 1984.

Mr. KUBARYCH. This is net.

Mr. PENNER. I realize it is net.

Mr. KUBARYCH. Revisions get made. Gross-fixed investment in the United States altogether was something on the order of \$575 billion in 1984. So, this is a small fraction of the total. That includes all fixed investment, durables, equipment, and structures. Nonresidential fixed investment is \$425 billion.

So, it is still a small fraction of the total investment being done, say \$20 billion out of \$400 billion.

Mr. PENNER. Let me be clear. My \$22.8 billion is consistent with your \$18 billion.

Mr. KUBARYCH. You may be more up to date.

Mr. PENNER. No; they are consistent numbers. The \$22.5 is investment of foreigners in the United States. Americans invested \$4.5 abroad, which gives you Roger's net number of \$18 billion.

Mr. KUBARYCH. Mine nets out. The correct proportion to look at, then, is \$22.5 billion representing foreigners investing in U.S. plant equipment and companies, out of a total fixed investment, nonresidential of about \$425 billion.

Mr. McMILLAN. But if I built a factory outside the United States, financed it in the European capital market, would it be included in the \$400 billion figure?

Mr. PENNER. If you built a plant in the United States?

Mr. McMILLAN. No; built it outside the United States and financed it outside the United States.

Mr. PENNER. And borrowed in the debt market?

Mr. McMILLAN. It would not be direct.

Mr. PENNER. No.

Mr. KUBARYCH. It would be a direct investment and it would be an outflow, it is a direct investment—

Mr. PENNER. It would be eventually, as you made profit and reinvested the earnings. But initially in terms of the balance sheet the equity wouldn't change.

Mr. McMILLAN. What I am getting at, in a period of prolonged high interest rates in this country, high relative to world capital markets which is one of the roots of capital transfers into the United States, has not in all probability a lot of U.S. expansion abroad been financed outside the United States?

Mr. PENNER. That was the point I was trying to make. You should look at the production levels in these U.S.-controlled firms differently from the actual flow of money capital. They need not be directly related for exactly the reason you enunciated.

Mr. MARTIN. These, of course, are very sophisticated money managers. They will transfer money balances back and forth among currencies and countries as it is their advantage so to do. They may finance one way today, but it doesn't mean it is forever going to be in that position and from that source.

Mr. McMILLAN. But one general conclusion might be drawn that the major portion of the net direct foreign investment of the United States is relatively short term?

Mr. PENNER. Not direct foreign investment, no. That I think is long term.

Mr. McMILLAN. I am thinking of all transfers. It is relatively short term and perhaps interest sensitive to a great extent.

Mr. KUBARYCH. Yes.

Mr. McMILLAN. OK.

Mr. PENNER. I think less than it was a year ago. Would that be right?

Mr. KUBARYCH. 1984 had a lot of purchases of long-term securities. But I know from great experience in this area that many of the purchases of what are called long-term securities are done for short-term motivations.

Mr. McMILLAN. Right—

Mr. KUBARYCH. And are quite easily marketable in a short time. Once a foreign investor senses a change in the bond market, it is

just as easy to liquidate a long-term bond as it is to liquidate a short-term CD.

The motivation is what you have to look at. Most of the investors buying bonds in our bond market last year did not intend to hold them for 30 years but to hold them as long as they were the best investment. They figured that would be a short period of time while that bond market improvement was continuing.

So, I think you are right in thinking of them as short-term investments. They are certainly easily liquidatable at short notice. In fact, they are held by money managers who move in and out of these markets at all times.

So, I don't think I can take comfort from the fact that foreigners buy long-term bonds, because they hold them for a shorter period of time until they don't think they are a good buy any more.

Mr. McMILLAN. They may reflect what you said, a lot of foreign investments are based on a high degree of confidence that we will do something about the deficit.

Mr. KUBARYCH. That is correct.

Mr. McMILLAN. That we do have a policy that is likely to bring interest rates down over time.

Mr. KUBARYCH. Correct.

Mr. McMILLAN. Whether fiscal or monetary. And their investment may not be strictly based on interest rates, but based on capital, expectation of capital appreciation.

Mr. KUBARYCH. Also correct. Very importantly.

Mr. MARTIN. And it may not show up in the balance of payments if we remember that we have the largest capital markets in the world by a very large margin, and that they may finance that plant or that set of stores or those restaurants or whatever it is in our own capital markets, not in the Euro markets, not in Tokyo but in New York.

Mr. PENNER. If I could add a footnote to this discussion, we have all been discussing these numbers very wisely, I think all of us would agree, however, that the data we are talking about are just terrible. These statistical discrepancies in 1984 were \$24.7 billion, greater than the entire amount of foreign direct investment that we have recorded.

Mr. McMILLAN. I was going to ask about that next. How do you arrive at that figure, errors, and omissions?

Mr. PENNER. In theory if we had a complete data, if we had all of the right numbers, the two sides of the balance, the balance of payments should be equal. But when we total up the individual numbers they are not. So, we know there is something very wrong with some of those numbers.

Mr. MARTIN. Some of that "something very wrong" is of course capital flows into this country that are difficult for the matrix of statistical monitoring devices to pick up. This is, of course, part of the problem of developing countries, the capital is here, however it got here and in whatever form.

Chairman LAFALCE. Mr. Levin.

Mr. LEVIN. I have been trying to catch up here. I thought at first I would finish reading the material and take it home but then I thought I might have nightmares if I read about it.

So, I am not sure.

I think the chart on page 3 that we have been focusing on in the last 15 or 20 minutes is very interesting. I read it more like the chairman does, in terms of its import.

I see it as showing that it is pretty easy for people to pull money out of this country pretty quickly.

Mr. KUBARYCH. Yes.

Mr. MARTIN. Yes.

Mr. LEVIN. That is how I read it; and that the investment here isn't because of any confidence in what we will do in the longer term but just to obtain some short-term gain.

All the time knowing that if the bottom falls out, it won't be overnight, and they will have a little time to pull out their assets.

That is how I read this chart.

As coarse as the data are, that is how I read it. I think all the Members of the House—we don't agree on lots of things—but there is a growing feeling of how deep the hole is.

I was reading the final statement, Mr. Martin, in your testimony and again I will try to catch up after the hearing and finish reading it all, you said thus our best hope for correcting international balances lies with efforts by the Congress and the administration to cut Federal deficits.

If that is our best hope, you know—I think it is a mistaken notion—if I might express a notion—that is sometimes not said clearly enough. It isn't because of the lack of will, it is because I think that the dilemma faced here is just as deep as the dilemma you face in calibrating your actions.

You are worried that if you open up too much, inflation would increase. You don't have any easy place to turn. But what is often forgotten is that there isn't an easy place here to turn. Anybody who thinks that there is understates the depths of our problems. I think the discussions in the last weeks in the budget process, those discussions manifest how deep the hole is.

That is what your message told me. Looking to other institutions to solve the problem has the implicit assumption, I think, that it is easy for the other institution to take the step that I think is every bit as difficult for them and we need to very much face up to that. I have come more and more to believe that. It isn't mainly a lack of will, it isn't that. I think it is partly a lack of will, perhaps, but it is much more complicated than that and there is good reason to declare everything off bounds, whether it is revenues, whether it is further cuts in defense expenditures.

Chairman LAFALCE. At different points we have declared Defense off bounds, Social Security off bounds, and revenues off bounds.

That doesn't leave much.

Mr. LEVIN. And I must say that another reason it is not just a matter of will, is that there is a lot of equivocation, even in the testimony of all of you. Each of your testimonies as I leaf through, it is kind of like Teyye—on the one hand and on the other hand. There are these dark clouds but there are these silver linings.

People grab a hold of the silver linings.

So I don't know what message comes out of this obviously unusually informed opinion. I don't know what message you are trying to give as the bottom line, or give your own institutions.

You are part of these institutions.

Mr. MARTIN. I think our message is we realize the extent of the dilemmas, how interrelated they are, fiscal and monetary policy, and trade and international payments policy, and that monetary policy cannot carry the load itself. We don't have the tools. We are not in such a happy position with respect to past growth of the aggregates, with respect to the level of interest rates today, with respect to the fragility of the financial system, that we can without fiscal policy help avert some of the international payments dangers that your three panelists have been talking about.

Mr. LEVIN. I was just in another meeting, to finish my comment, I came here from a discussion of the international picture and there was strong condemnation of actions yesterday of proposals labeled protectionist. Two of the three people sitting there that signed on to that legislation, including myself because we don't look upon it that way, we look upon it as protective, not protectionist legislation. I don't think there is a full cognizance outside of Congress as to how deeply concerned people are about the eroding economic base of this country.

What are we going to do about it? You can talk about these direct—it goes back to the chart on page 3. I find this very alarming. I think the direct investment figures, I know they are very coarse. Errors and omissions, too, I wondered about that, too.

Mr. McMILLAN. I would like to have some of that.

Mr. LEVIN. So would I. It reminds me of my checkbook at home. But seriously, direct investment is something that, you know, people are not investing here on a long-term basis—I would think from this chart—this is the safest place for short-term lodging of their dough. That is how I read this chart with the trade figures there.

I think this is scarey stuff.

Chairman LAFALCE. Easy in, easy out.

Mr. KUBARYCH. But they are making judgments about the long-term when they put primarily short-term money here. They are still making favorable judgments about a course of policy development that will not make them look like they have made a bad mistake. So they are assessing, for example, prospects for settling the budget deficit.

If you talk to people in the exchange market today—and the dollar has been declining for several weeks now little by little—they will cite the failure to come to a compromise on the budget as one of the factors that is starting to bother the foreign investor. They will react by trimming back some of these positions.

Mr. LEVIN. I agree. Just to close for a second time, I agree with that but I don't think—what we are saying I think is in the United States we won't let banks collapse so they won't be embarrassed in terms of losing things overnight.

But they are not showing very long-term confidence if you look at this chart. I don't see that long-term confidence.

Mr. KUBARYCH. That would be true.

Mr. LEVIN. Again, it is hard to know what the terms mean, but direct investment, you compare—by the way you look and see how much of that direct investment comes from automobile manufacturers who have no choice now, you know, who really figure that

this is it. You take that out of the picture and I assume it is in here, direct investment of the Japanese automobile manufacturers.

Mr. KUBARYCH. Yes.

Mr. LEVIN. But what do you have left if you take that out? I think—I just don't see that expression of a safe haven in the very long run.

Chairman LAFALCE. Let me pick up the questioning on investment with a different slant.

Dr. Penner, on page 20 you say it may be appropriate to import capital for brief periods, if the resource is invested in productive investments as opposed to being used to finance public deficits.

At our hearing on Tuesday, we heard from David Hale of Kemper Financial Services and he was worried too much of our private investment is going into constructing office buildings, for example, and defense industries and far too little of our investment is going into civilian manufacturing.

Do you have any data on this? Do you share that concern? Do any of you have data?

Mr. PENNER. I am not sure exactly what he meant. The major concern that I have in that line is that our tax laws concerning taxation of capital income in this country are in a quite extraordinary mess. The effective tax rates on various investments depends crucially on whether they are corporate, noncorporate, debt financed, equity financed, or whether there are a lot of inventories or not, and on and on and on.

So I think in general terms it can be said with considerable confidence that we are misallocating capital terribly in this country because the composition of investment is so determined by the tax law as opposed to where it is truly productive in our society.

That is a big concern and I think, in particular, some of the office construction is indeed related to the tax law. So if that is what he was talking about, I would certainly share his view.

Chairman LAFALCE. Governor Martin, there are many different forms of debt, and another issue of debt with which we are greatly concerned is the Third World debt. Surely our own budget deficits which contribute to our high real interest rates which contribute to not only our debt service, but to the Third World debt service is a contributory cause to their problems, and to the world's problems.

What else should we consider doing to help alleviate Third World debt? Clearly, by buying so many of their goods as we have these past several years, we have assisted them greatly—more so than any other country at the expense of our own industries, that is for sure—but what else should we be doing or thinking of doing to help alleviate the problem of a potential time bomb of Third World debt?

Mr. MARTIN. Well, we have been discussing our own domestic policies and again, the hope that there would be action on the deficit here in this country. But other measures needed are to resist protectionism, especially that type of protectionism which would slow the flow of exports out of the developing countries, particularly the Latin American countries.

We are pursuing in the various international conferences, the G-10 conferences and other conferences, an exchange of views with

respect to the economic policies, particularly fiscal policies but also monetary policies, of our trading partners.

As the chairman knows, the rates of economic growth are very low in most of our trading partners. The mix of monetary and fiscal policies is quite restrictive. You have actual trade surpluses that are the other side of the coin from our deficits in some of these countries.

So a coordination if you will or similarity between expansionary policies, careful expansionary policies in our trading partners, will of course expand the markets for the exports of the developing countries.

Chairman LAFALCE. Mr. Kubarych has said in his testimony that to a certain extent, we have to foster a more stimulative fiscal policy among our trading partners.

Mr. MARTIN. Yes, sir, and the old British motto of "export or die" applies exceedingly well to those developing countries. They have to get through this phase I period.

Chairman LAFALCE. I guess I read someplace that you made a statement that the United States might have to take the lead in doing something—some extraordinary things.

Mr. MARTIN. In phase II, after the crisis.

Chairman LAFALCE. In dealing with the problem of Third World debt. I wasn't sure what you had in mind by that. Could you expand upon that?

Mr. MARTIN. Surely. I was addressing the phase II post crisis question with a group of multinational businessmen in New York, business firms with investments in the developing countries. We were together discussing the opportunities for protecting and managing investments in the developing countries in the long run. After phase I in which they have made the internal adjustments, painful as they are, in which they have their exports up, in which their export-to-debt-service relationship began to come into normal configuration, and what happens then? How can multinational business firms invest and protect investments in the phase II countries?

That is, of course, a different question from how you get through phase I. How do you make the internal adjustments that are so necessary to get the growth of the money supply down, reduce the subsidies to your own industries, reduce the deficits in the developing countries and get your exports growing.

Chairman LAFALCE. Anything else?

Mr. McMILLAN. I have one.

We are sort of getting into the trade question, and several of you, I think two of you at least, prefer to express a deep concern which we all share against artificial restraint, I think, was the phrase.

We see things happening, the textile bill, timber problems, perhaps other heavily-impacted industries in this country. There was a bill introduced yesterday in the Senate, 25 percent surcharge approach as another way of dealing with it. Others to do enforcement of previously-negotiated quota systems, the whole range of options.

I think the Congress is very much under pressure from a variety of constituencies on this issue. That is the other side of that \$150 billion trade deficit.

I think most Americans, and I would count myself among them, believe very strongly in free trade, but the question that I am faced with is that a lot of my constituents being adversely affected by our trading position are not involved in a free trade situation in that many of their problems are created by artificial stimulation on the part of exporters to this country, and in that I would include a wide range of subsidies, and you can go on and on and on with that, beginning with the tax rate, low interest loans, direct investment, targeting of products and so forth.

It seems to me our trade policies have got to get to a point where they are more realistic, more realistically reflect the real world situation in which we live. Free trade, it seems to me, is an ultimate objective, and that everything we do should be designed to achieve that objective.

But to simply unilaterally say we are going to maintain that posture and allow basic industries in this country to be destroyed in the process is just probably going to be politically impossible for us to do and Congress is very likely to be responsive to those pressures.

What we need to do is develop a sensible way of dealing with them, a rational way of dealing with them.

I would really like some comments from you all if you care to make them, on that very question. The way to get to free trade may well be to create a level playing field as they say, and where other nations are perhaps providing some artificial stimulation to the exports of this country, then if they don't acknowledge that as part of a negotiated trade agreement with that country, then maybe the best way to get them to stop or to create the level playing field is to do so artificially, since they are artificially stimulating those exports into the country.

Mr. KUBARYCH. The playing field in Brooklyn where my son plays little league baseball, is not a very level field because they don't put much money into Prospect Park. But think about it this way: There are these gaping holes in the Prospect Park playing field that fill up with water every time it rains, and you would like to level that off. You can level it off in two ways.

You can get some dirt and fill in the holes and level it that way, or take a bulldozer and level off the rest of the field down to the level of the bottom of the hole.

Now, that is a perfect metaphor for the trade problem. We can level the entire playing field at much lower levels of world trade and we know how to do that with various restrictions; or we can level the playing field up by filling in the holes. The holes are inadequate demand for manufactured imports, primarily from the developing countries in Europe and in Japan.

So the term I like to use is that we need the Japanese and, to some extent, some of the European countries to adopt an "affirmative action program," a program that sets some pretty hardnosed targets for how many imports, primarily from developing countries, they are going to try to achieve. And we would want them very definitely to achieve them over a reasonable time.

Where we get into the area of being wrong is to view the trade problems as bilateral problems. I have tried to emphasize, and I think many people in the business community share this kind of

analysis, that you don't solve the problem of the level playing field in trade by focusing on bilateral trade problems such as vis-a-vis Japan.

You have to accept that, at the margin, our best customers tend to be developing countries. They need to do better in their own exporting drives throughout the world, primarily in countries like Japan that can afford to buy their products.

That is the kind of deal that levels the playing field up, at a very much higher level of world trade. In the end, it is cheaper to fill in that hole than to take the bulldozer and grind down the level of world trade. To achieve that result there has to be serious negotiating effort. I am not altogether opposed to some of the pressures that have emerged in the Congress, because they will maybe awaken officials and businessmen in these other countries about the need for becoming better customers for these countries' products.

But don't start with the bilateral problem and move in the direction which will inevitably reduce the overall level of world trade, because the result will be very expensive for everybody.

Chairman LAFALCE. Does anyone else have any other questions?

Let me just ask one last question of Governor Martin.

Let's suppose that very shortly I am going to be President of the United States, and let's suppose shortly you will become Chairman of the Federal Reserve Board. One might be unlikely, the other might be much more likely.

How should we reduce the deficit, practically speaking? Again, I have no ideological blinders. What else should we do to improve the U.S. economic picture, especially its trade competitiveness? Counsel me.

Mr. MARTIN. With respect to the Federal fiscal position, the way to start is to review the expenditure areas first, and then consider the revenue producing areas.

I think that in the review of the expenditures, the question is a political question, not a financial or economic question. It is, whom do you want to help? What are your objectives in terms of the various groups in the economy, including the various income levels in the economy? What kinds of means tests, what kinds of criteria should be applied program by program? In other words, the kind of reviews that are already going on.

Then there is a revenue side. If the deficit can't be reduced enough on the spending side, of course, it has to be attacked from the revenue side. There the question is one that involves in part international competitiveness, and, as you posed the question very well, Mr. Chairman, earlier, of what could be done in the tax structure to encourage research and development expenditures, higher productivity resulting either from the incentive side or from the investment side, and no one knows the complete answers to that question.

As to what else can be done, I go back again to the absolute necessity of a coming together of the fiscal/monetary mix in the major countries of the world. If anything comes through this great mass of data—

Chairman LAFALCE. Would you have counseled the President to have had simultaneous international monetary discussions along with the trade discussions that he was promoting in Bonn?

Mr. MARTIN. I think that whatever can be done in the multilateral, multinational negotiations with respect to fiscal policies first, but monetary policies, too, and trade restriction policies and subsidization of domestic industry—the whole cornucopia of policies needs to be brought together in the major trading partners.

Chairman LAFALCE. Let's take the issues one by one. Take subsidization of basic industries.

Basically, our approach has been, it seems to me, to get all the other countries to use the bulldozer and take down the Prospect Park, apparently, and they don't seem to be willing to use the bulldozers.

Should we start filling in the holes in the United States?

Mr. MARTIN. I don't think we have exhausted the possibility of negotiations here. It seems to me that we still have a way to go before we throw up our hands and say, well, they are not going to do anything about their fiscal policy.

Chairman LAFALCE. I am President now and you are Chairman of the Fed, and I said I was not coming to the table with ideological blinders.

Are you coming to the table with ideological blinders when you say we have not exhausted the possibilities you mentioned? Haven't we pretty much explored them all for a long period of time at great length, Governor?

Mr. MARTIN. Yes, Mr. President, we certainly have.

Chairman LAFALCE. How about filling in some of the holes?

Mr. MARTIN. I am only making the plea now, Mr. President, that since you are new in office, since you have a big problem, that you make one more try.

Chairman LAFALCE. Let's go back to the international monetary talks. Do you think that it is possible for the United States to talk international, fiscal, and monetary policy? Do you think it is possible for the United States to tell other countries that they should stimulate their policies fiscally, given the present ideology of this administration?

Mr. MARTIN. Yes.

Chairman LAFALCE. Isn't that what is called for?

Mr. MARTIN. Yes, sir. I think the pressure which is exerted on the U.S. negotiators, whether it be yourself, the President, or Mr. Yeutter or anyone else in these meetings, where certainly we are told what we should be doing in the United States. That seems to be item A on every international agenda of any meeting I have ever been to.

How about items B, C, D, and down to the end?

Chairman LAFALCE. Well, others do advocate that we do that, but we tell them "cut your taxes."

Perhaps we should be asking, what about stimulating your economies by fiscal policies, which might not mean just cut your taxes.

Mr. MARTIN. Right.

Chairman LAFALCE. It could mean increase your spending, and increase spending on certain consumptive items such as in Japan, for example. We have not done that, to my knowledge.

Should we do that?

Mr. MARTIN. I can't speak to whether we have done that since it is typically the Secretary of the Treasury that does that. I am not privy to what he has been doing there but I would certainly support any pressure or any strong negotiations on his part in that way.

Chairman LAFALCE. You are much more involved in monetary policy, but I am talking fiscal. Insofar as monetary policy is concerned, do you have informal and formal meetings and arrangements, with other central banks?

The European countries do have formal and informal arrangements to keep their currencies within a certain band, if you will.

What do these central bankers of the world think of our attempt to keep our currency within a certain band? Have you advocated this in international circles, and have you done it in domestic circles in the United States at 1600 Pennsylvania Avenue?

Mr. MARTIN. We meet at least monthly, Chairman Volcker, myself, Governor Wallich, at the Bank for International Settlements. We meet at various other meetings of the Group of Ten, on the IMF, and many times on an informal basis. We share information with regard to the developing policy mix—how it is being implemented in each of the countries—and exchange criticisms, if you will, as to how it is working here and there. I find that there does seem to be some shift in emphasis in central banks around the world toward more attention to exchange rates and somewhat less attention to the monetary aggregate.

In fact, in the case of Canada, there was a move away from the monetary aggregate and an overt concentration on exchange rates. So it would seem there is a movement in that direction.

Chairman LAFALCE. Do we have enough movement in that direction within the United States either from the Federal Reserve or from the administration?

Mr. MARTIN. I believe, concentrating on monetary policy, we have about the right emphasis at the moment on the international markets, exchange rates, strength of the dollar, as was, I hope, evidenced—

Chairman LAFALCE. Do you agree with that, Mr. Kubarych?

Mr. KUBARYCH. I think there is enough flexibility, given the inflation situation, where the Fed could be a little more generous in bringing down interest rates at this particular time in a gradual, nonhighly publicized way.

Mr. MARTIN. No comment.

Mr. KUBARYCH. I couldn't have said that in my old job.

Chairman LAFALCE. We couldn't have asked you here if you were in your old job.

How does our system and the other systems of the world compare with the European system?

Mr. MARTIN. In the monetary area?

Chairman LAFALCE. Yes.

Mr. MARTIN. Well, we are—

Chairman LAFALCE. This is primarily concerned with exchange rates, isn't it?

Mr. MARTIN. Certainly, country by country it varies as to emphasis, but in every case the exchange rate is high in their consideration because in many of these countries trade is 25 or 30 percent of their GNP rather than 8 or 10 or 15 as in our country and similar countries.

Chairman LAFALCE. What figure were you referring to?

Mr. MARTIN. I was referring to the proportion of GNP represented by the import-export flows in other countries. Since in these other countries it is a larger proportion of the GNP, there is more attention to the exchange rate but I don't mean to imply—

Chairman LAFALCE. What is it in the United States now?

Mr. MARTIN. I don't have the figure.

Mr. PENNER. I think it is close to 20 percent.

Mr. MARTIN. Imports are about 10 percent of the GNP in real terms.

Mr. KUBARYCH. Exports are a lot smaller, unfortunately.

Mr. MARTIN. Unfortunately, yes.

So there is that attention that in part relates to how much of the economic base is commanded by their export industries. Ours are important, theirs are more important.

But there still is attention to the domestic rates of growth in the Federal Republic, in France, the United Kingdom, and in Japan. There certainly is attention to each of the domestic economies.

That doesn't mean that they ignore the monetary aggregates, or don't look at their own economic growth rates, but there is more emphasis on exchange rates and trade balances than is true, I think, of ourselves.

Chairman LAFALCE. Anybody else care to comment?

Mr. KUBARYCH. I think the reality is that most of the European countries are pretty comfortable with their policies right now.

They are trying to position themselves in a different mode than the United States. They are trying to show that slow, gradual growth is more sustainable.

They are not upset at all by the fact that they have large trade surpluses in a number of cases, and they are not terribly cooperative when any of the consequences of this relatively slow growth, trade surplus policy are brought to bear on them. They don't really respond very well.

There is a very large, arduous task ahead to change their viewpoint. Their viewpoint is that what they are doing is right, not that they are growing too slow or not importing enough. They don't choose to have larger imports.

So the reason we don't have some of these coordinated packages of measures is because most parties are either stuck internally in a set of policies and can't change them, or are pleased with what they are doing, as, for example, in Germany, and don't want to change.

Chairman LAFALCE. Well, thank you very much. We could go on endlessly, but there are other demands on your time and our time.

I want to thank the panel. It has been extremely educational and informative, and we thank you for your assistance to the subcommittee.

The subcommittee will be adjourned.

[Whereupon, at 12:02 p.m., the subcommittee adjourned, subject to the call of the Chair.]

IMPACT OF THIRD WORLD DEBT ON THE U.S. ECONOMY

THURSDAY, JULY 25, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ECONOMIC STABILIZATION,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:45 a.m. in room 2220, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Representatives LaFalce, Kaptur, Torres, Carper, Kanjorski, and Grotberg.

Chairman LAFALCE. The Subcommittee on Economic Stabilization will come to order.

Our hearing today will examine the Third World debt situation from the perspective we have found helpful in discussions of industrial policy.

Since 1970, the U.S. economy has become much more integrated with the rest of the world, in our financial sector as well as in our goods producing sectors. It is widely known that exports and imports have doubled their share of our goods production since 1970. It is less widely known that foreigners now hold half the deposits and have borrowed half the loans at many of our major banks.

Three years ago, Mexico announced that it could not meet its scheduled debt service payments. Many other Third World countries soon followed Mexico's lead.

The U.S. Government had an important role to play in maintaining stability in this situation. The Congress replenished the IMF with funds. The Treasury Department and the Federal Reserve both have participated in rescheduling discussions between bank consortia and individual Third World countries on a case-by-case basis. Even the Export-Import Bank has contributed extra funds to key debtor countries.

It is time to take stock of the actions taken by the key players during this period of U.S. Government intervention. Have the various players been making the necessary adjustments to achieve stability in the longer term without government help?

For example, have the banks taken measures internally to improve their ability to withstand shocks in the future? Have they diversified to reduce their risks, cut costs and set aside adequate loan loss reserves? Have the debtor countries taken actions internally to improve their capacity to cover their debt-servicing costs?

In their negotiations with debtor countries, have the banks, the U.S. Government, and the IMF put enough priority on strengthening their economies?

We look forward to our witnesses' answers to these questions, but recent World Bank figures give us some concern. They suggest that the Third World's debts continue to grow faster than their ability to pay. Their debt as a percentage of their exports rose from 97 percent in 1981 to 135 percent in 1984. Similarly, their debt as a percentage of their GNP climbed from 22 percent to 34 percent during that same time frame.

The shifts in financial flows to the Third World have taken their toll on Third World imports and, as a result, on U.S. exports. According to one recent estimate, the United States has lost \$800,000 jobs from the turn of events in Third World debt. Could anything be done to reduce that cost for the United States?

What about the economic and social costs in the Third World? Living standards have fallen 10 percent or more in many countries since 1981. Can that burden be eased?

And, finally, what are the prospects for the future? Studies done a few years ago concluded that this was largely a shortrun liquidity problem. However, those studies assumed that industrial countries would grow at a 3- to 4-percent rate to boost Third World exports and that real interest rates would return to historic norms. Unfortunately, however, growth is already falling short of 3 percent in the United States and much of Europe.

Exports by Argentina, Brazil, and Mexico were all declining in the first quarter, and interest rates remain at historically high levels in real terms.

We are privileged to have distinguished witnesses today who can provide us information on three facets of this issue.

For three decades, Dr. Raul Prebisch has held a number of key United Nations' posts related to Third World economic issues. In addition, he has recently advised the Government of Argentina on its external debt problems. Martin Mayer has written several thoughtful books on banking issues in the last 10 years; and Stuart Tucker has followed the effects of Third World debt problems on U.S. exports for the Overseas Development Council, an organization that has disseminated much useful information on this issue.

I advise all members of the panel that we will include your prepared statements in the body of the record and you may feel free to summarize your remarks, if that is your preference.

Mr. Tucker.

STATEMENT OF STUART K. TUCKER, FELLOW, OVERSEAS DEVELOPMENT COUNCIL

Mr. TUCKER. Mr. Chairman, I am honored and pleased to be invited to testify on the sectoral costs of the Third World debt problems for the United States. This subject is of considerable importance, not only to the United States, but to developing countries.

The following views I express will be my own and should not be attributed to my colleagues at the Overseas Development Council or its board of directors.

I will summarize my statement, which in itself is a summary I have done for the Overseas Development Counsel on the costs to the United States of the recession in the developing countries.

The question that I have been asked to address is largely the effect of this problem, the debt in general, on U.S. industry and the sectoral costs to individual industries in particular.

I review some of these effects over the period of 1980 to 1984, but first I would like to---

Chairman LAFALCE. We are the Subcommittee on Economic Stabilization and, therefore, we wanted to see the effect Third World debt has had on our economy and the effect that future prospects for Third World debt might have on our future economy.

Mr. TUCKER. Well, what I would like to do is point to the whole question of how important our exports are in indicating the problem of the debt.

First, I would like to look at the trade deficit and get to some of the causes and point to the fact that the debt problem is a major cause of our trade deficit. And the reason I would like to point to this is that there has been a great deal of talk about protectionism, about the overvalued dollar that we have, about unfair labor practices and other measures.

My study essentially says that although protectionism and the overvalued dollar are important factors, they are not the major causes of U.S. export problems and of what is called an import surge. In fact, it is the debt problem and in general the recession in the developing countries which is also largely tied to the debt problem.

The problem is not the dollar, although the dollar is a negative factor. If the dollar had been the only factor, our exports would have been declining for 4 years and our imports would have been increasing for 4 years and our trade deficit would have had a 4-year period of moving toward the negative side.

However, in 1980 through 1982 that was not the case. It was pretty much stable, and in fact our deficit with developing countries was decreasing. It was moving toward a balance rather than away from a balance. It was only in the 1983 and 1984 period that this changed. So for 2 years the dollar did not have a major effect upon our trade deficit.

Further, in 1984, although the dollar grew in value another 8 percent relative to other currencies, the share of U.S. exports to developing countries out of industrial country exports actually began to rise so that we were not really being hurt relative to other industrial countries during 1984.

So in effect over a 4-year period only in 1 year would we have been correct if we had predicted from the value of the dollar what would have happened to our exports to developing countries.

Now the deficit is not due to protectionism either. If you look at our trade deficit with individual countries, you will note that of our top 40 trading partners who actually account for over 90 percent of our trade, only 9 have a trade surplus with us. We are in deficit with most of our major trading partners, and in the top 10 none of the countries actually buy more goods from us than we buy from them.

This is a widespread trend that seems to indicate that it is not individual countries taking protectionism, but it is in fact a broader problem that has very little to do with the individual government actions that are taking place abroad.

I am not denying that protectionism is on the rise. It is in fact rising in many countries, but it is not the major cause of our export performance.

So I get to the point of what is the major cause, and find two causes.

Generally our economy has grown much faster than other countries, including other developed countries who would be buying the exports of developing countries. This has drawn in imports and it has also meant that our exports have not been able to go abroad because other countries are not growing as fast to buy our imports.

The second cause is the debt problem. The debt problem has had a significant effect upon the United States in the sense that developing countries have stopped importing over the period.

In the period of 1980 to 1984 developing countries' imports fell 19 percent. Our exports to developing countries fell slightly more than that but not significantly more. So again it may not be really the dollar, but just simply the problems of developing countries importing.

This is probably mostly attributable to the debt since our exports to debtor countries in particular have fallen even greater than our exports to developing countries not necessarily besieged by the debt as much.

So with that background, I would like to move to the actual costs to the United States and make some remarks about the future and what we can expect.

You mentioned the figure of 800 million jobs. It is anybody's estimate, but we have attempted—

Chairman LAFALCE. 800,000.

Mr. TUCKER. 800,000, I am sorry. It is anybody's estimate as to whether that is correct or not. We have attempted to look at the general structure of the U.S. economy in 1980 and, if there had been no recession, what it should have been in 1984 and looked at it in relation to what we actually have seen.

Our fall in exports, in our estimation, has directly cost 560,000 jobs that used to exist and another 800,000 jobs that should have been created if exports had grown at the typical pace of the 1970's. So in effect we would estimate that 1.4 million jobs have been lost because of the problems in developing countries.

Now again, part of that is the dollar, part is protectionism, but most of it is the debt and the growth problems due to the world recession.

Over the 4-year period, 1980-84, this added up to 3.2 million person-years of employment, which on the average over that period of time was about 8 percent out of our unemployment.

Now this has hurt our non-agricultural exports predominantly, and of those manufactured exports in general, I took a look at over 100 major export industries classified as major because they were significant parts of our economy or they were significant in terms of developing countries receiving most of those exports and looked at them and found that over 80 percent of each of these industries

has had a real export fall over the 4-year period. Less than 20 percent of the industries I have studied have actually gained in export markets.

In general some of the major sectors that have been hurt have been aircraft, motor vehicles, transportation equipment, and power-generating equipment, and the success stories have been fairly limited to a narrow sector involving electronic computers and office machines. So our economy has been hurt on a wide span throughout our manufacturing sector.

As just a side note, our service industries have also been hurt. The 1.4 million jobs that I mentioned are not just in the industries that export, it also takes into account service industries that support those industries. So our service industries have also lost something during this period due to the problems with developing countries.

I could go into further effects, but generally I will say that U.S. exports to developing countries in those cases where we have actually seen rises, the export increase has been less than we have seen in our exports to the rest of the world.

In those cases where U.S. export sectors have lost jobs due to the decline in exports, there also have been increases in exports to the rest of the world in some of those cases.

So, in general, we can see that the debt problem has been important, and the real question is what is going to happen in the next few years and will that affect U.S. industry.

If we look at the last 4 years, we have to say that whenever there is a recession in the growth prospects in developing countries due to any cause—but especially due to debt whereby the countries have to export more than they import in order to pay off the debt—this hurts U.S. exports. With the U.S. economy beginning to slow down, European countries not having tremendous growth prospects in the next few years and developing countries having a significantly weaker recovery than they usually have from recessions, one would have to say that the next few years will be rough on U.S. industry. Already the figures are fairly bleak. As you pointed out, in the first quarter some countries have had problems in raising their exports.

Under these circumstances we can expect that developing countries will find fewer markets to export to and as a result they will have to compress their imports in order to meet their debt-service needs, and U.S. export industries will be hurt yet again.

This is perhaps more important to our economy over the next few years than over the last 1½ years precisely because if our economy begins to slow down, we will no longer have the domestic market to be selling to, and those lost export markets will then just add a second spear in our side and result in virtually no markets expanding for much of our manufacturing industry.

For that reason I find it very crucial that the debt problems over the next few years be relieved, if not in a long-term manner, then certainly in a temporary manner, or the business cycle downturn that we are entering into could have a severe effect on our industry.

I could go on and talk about solutions, but I think we have heard many testimonies about solutions on the Hill, and I would be

happy to answer questions about what I think we might do in the future.

Chairman LAFALCE. No; I would ask you to take a few minutes to discuss that if you don't mind.

Mr. TUCKER. All right. What I would like to point out is that if the debt crisis is accepted to be a major problem, then solutions have to address the problem and not the symptoms.

The debt crisis has forced countries to have surpluses with the United States, and people are beginning to complain about an import surge. Well, in fact, due to the growth that we have had, our imports have not changed significantly as a percentage of our GNP. There is no significant import surge. So the protectionist action that has been suggested in some quarters may be premature.

Instead, we should be looking at what is causing these countries to compress their imports and therefore creating our trade balance via our export sector, and in that sense we should be trying to alleviate the debt crisis and not attempting to punish countries who are exporting more to us than they are importing from us.

Second, the overvalued dollar has had some impact and that needs to be addressed, and that should be addressed again through the most direct means, through effecting an exchange rate and not by levying some temporary surcharge which makes up for the overvalued dollar.

Chairman LAFALCE. How do you effect the exchange rate?

Mr. TUCKER. Well, the bottom line of that is that we need to lower interest rates and most economists would say that the best way to lower interest rates is to affect the U.S. budget deficit. There is no way that we can avoid that. It has affected the dollar and that is an important factor in any solution to the debt crisis.

The second effect of reducing the budget deficit would be that its effect on interest rates would help alleviate the debt problem abroad as well in the sense that the interest that they pay on their loans would be reduced.

And, finally, if we are to make sure that we revitalize our export prospects over the next few years, in addition to relieving the debt crisis and affecting the budget deficit, we need to be moving quickly toward freeing up the world trade system in a way that will keep trade moving. Instead, in the last few years we have had situations where countries have been very distrustful of other countries' actions and have not been willing to liberalize their own economies and have actually retaliated for actions that they perceived in other countries.

What we must recognize is that when it comes to a developing country, this protectionism to compress imports is precisely what the United States has advocated for these developing countries so that they can have a trade surplus and pay back their debt. As long as we are advocating that, we cannot at the same time also complain that they are succeeding at exporting more than they are importing. So protectionism against their products is foolish if we find that expanding exports is the only way their debt crisis can be resolved.

So in that sense, moving toward a new trade round, or at least some sort of liberalization on a more informal level, would also be

a measure that would be useful for moving the world trading system forward in a way that developing countries can meet their debt problems.

I guess I will stop there.

Chairman LAFALCE. You didn't mention what to do about the debt that has already been accumulated in the debt service.

Mr. TUCKER. There have been a number of suggestions, and I don't really have the authority nor the expertise to comment on what the best financial suggestion would be. However, it is fairly clear to me that we cannot maintain a large import excess over our exports for a long period of time.

It makes sense, therefore, that these developing countries should not also be required to export more than they are importing, especially in the time when they are trying to adjust to their own problems, meet social pressures, and in some countries move toward some level of democracy. Under these circumstances it makes sense to relieve their debt for a temporary period of time. This can be done through a variety of methods. Putting a temporary cap on interest rates would be helpful, deferring interest rates either through recapitalization or temporary—well, I will say essentially allowing the countries not to pay back fully the interest payments.

I would not go so far as to say the banks should never be repaid, but the banks have already begun to realize that they are not going to get every single penny back. It makes no sense to bring every penny back from those countries if it is going to affect the whole world economy.

Under these circumstances, if the reality is that the debt has to be alleviated, there is no point in talking about it for 2 to 3 more years and letting it accumulate.

[The prepared statement of Mr. Tucker follows:]

STATEMENT OF STUART K. TUCKER
FELLOW, OVERSEAS DEVELOPMENT COUNCIL

before the
Subcommittee on Economic Stabilization
of the

HOUSE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

Washington, D.C.

July 25, 1985

Mr. Chairman, I am honored and pleased to be invited to testify on the sectoral costs of the Third World debt problems in the 1980s. This subject is of considerable importance, both for the United States and the developing countries. The following views are my own and do not necessarily reflect the opinions of my colleagues at the Overseas Development Council or its Board of Directors. I will draw extensively from a study I am conducting which will be published by the Overseas Development Council as a working paper entitled, "Update on the Costs to the United States of the Recession in Developing Countries."

Congress is well aware of the magnitude of the debt which developing countries owe U.S. banks, not to mention the international financial system as a whole. The repeated headlines of country after country running into troubles paying back financial debts are hard to ignore.

The question that I would like to address at this hearing today is the costs to the United States' economy of these financial problems overseas. More

specifically, my remarks will focus on the performance of U.S. export industries over the period 1980 to 1984. First, however, a few remarks about the cause of the U.S. trade deficit are in order.

THE U.S. TRADE DEFICIT

In recent months, there has been a great deal of attention given to the size of the U.S. trade deficit--\$173 billion last year and likely to be \$150 billion in 1985. The U.S. trade deficit with developing countries was \$53 billion in 1984. Many causes of the deficit have been proclaimed. Our trading partners have been accused of protective practices to keep U.S. products out of their markets. The dollar has been accused of various ills, including driving up the price of our exports and making the price of imports irresistibly cheap. Some countries are even accused of unfair labor practices which make their products cheaper than ours. To some extent, all of these are true. However, neither individually, nor together, do these explanations fully account for the tremendous shift in our trade balance which we have seen over the last two years. Nor are they the most significant causes of the U.S. deficit with developing countries.

The major causes of the U.S. trade deficit with the Third World are the burden of the debt and weakness of the world recovery, especially that in developing countries.

A quick glance at U.S. trade with our top forty trade partners shows that the trade deficit is not primarily caused by protectionism and export subsidies abroad. Of these forty countries (which accounted for over 90% of U.S. trade in 1984), only nine bought more from the United States than they sold. Of the top

twenty partners, the United States was in trade surplus with only four. If protectionism abroad were the problem, then we should expect to find our trade deficit concentrated in those countries with the most unfair trading practices. However, the U.S. trade deficit is spread widely among almost all of our partners. Even such open market economies as Germany and Singapore bought less of our goods than we bought of theirs in 1984. Despite clear signs that there is a move toward protectionism world-wide, I find unsustainable the proposition that, all of the sudden in the last year or two, every one of our trading partners more actively blocked U.S. exports and subsidized their own exports to the United States.

Of course, some of our partners have indeed compressed imports and promoted exports, using barriers and subsidies. For the most part, these countries are the developing countries that are suffering from debt crisis. This trade policy action should be seen as a result of the pressures to service the debt. In fact, the United States, through the IMF and banking policies, has supported this sort of trade policy in the Third World as a means for resolving debt problems. Thus, any U.S. trade deficit resulting from these policies must be seen as a result of Third World debt, not unfair trading practices.

There is also considerable evidence that the value of the dollar, although certainly a negative factor for the U.S. trade balance, is not the major cause of the U.S. trade deficit with developing countries. If the overvalued dollar (in 1984, 44% above its 1980 value and 35% above its 1975 value) were the main problem, then we should expect that the U.S. trade balance would have moved in the negative direction at the same time as the dollar gained strength. However, in the period 1980-82, while the dollar jumped in value by almost 26%, the U.S.

trade balance hardly changed at all. In fact, the trade balance with developing countries improved during that period.

Further, an overvalued dollar should cause the United States to lose export market shares to our competitors. While this indeed did happen, the effect has not been striking. In the period 1980-84, total Third World imports fell in real terms by 19%. U.S. exports to the Third World fell in real terms only 22%. This is very close to the 19% fall that we should expect if the dollar's value did not change at all. Thus, the overvalued dollar only contributed 3 of the 22 percentage-point fall in the real value of U.S. exports to developing countries. Of course, the actual value of U.S. goods sold abroad was kept high by the value of the dollar, but even when measured in volume terms, the trends of U.S. exports did not follow the path of the dollar. In the period 1980-83, the U.S. share of the volume of OECD-country exports to the Third World did fall from slightly more than 27% to 22%. However, in 1984, while the dollar still rose another 8%, the U.S. share of the volume of OECD-country exports stabilized and began to rise. Also, while Third World imports from the world fell 1.8% in real terms in 1984, real U.S. exports to the developing countries fell only 0.7%.

In sum, if one had been asked to predict the path of U.S. trade with developing countries based only on the trends in the value of the dollar during 1980-1984, one would have been wrong in three out of the four years.

One major cause of the U.S. trade deficit is the global pattern of the recovery. In short, the United States has grown much faster than most other countries in the world. In 1984, the United States' economy grew 6.8%, while the other industrial countries grew 3.5% and the developing countries grew 3.7%.

This has had a very predictable effect on the U.S. trade balance. With the U.S. market being the fastest growing one, the recovery of other countries' exports have been centered on selling to the American consumer. More importantly, the export imperative facing the debtor countries has forced them to export more than they import. Since the European industrial countries have been experiencing a slow recovery, they have not been able to buy as many of the Third World's goods as has the United States.

The effect of this difference in growth rates can be seen in world trade statistics. The U.S. share of world imports rose from 13.3% in 1980 to 18.5% in 1984. Also, the U.S. share of the industrial-country imports has risen from 18.8% in 1980 to 26.0% in 1984. These trends also hold true for imports by industrial countries from developing countries. The U.S. share of industrial-country imports of all commodities from the Third World has risen from 32% to 40%. The U.S. share of industrial-country imports of Third World manufactures has risen from 39% to 53% for the same period. Yet, despite these increases in the American share of world imports, the share of imports as a percentage of U.S. GNP has not risen since 1980. In fact, U.S. imports of merchandise as a percent of GNP fell in the recession and bounced back in the recovery, but is still slightly below the 1980 level. Thus, it is incorrect to say that the United States has been experiencing an extraordinary import surge. It has been nothing more than should have been expected during a recovery.

The more significant effect of the differences in world growth is the fall of U.S. exports. / In 1980, U.S. merchandise exports accounted for 8.4% of GNP. By 1984, that figure had fallen to 5.9%. Even if one adds in the export of services, U.S. exports fell from 12.9% of GNP in 1980 to 10.0%.

Thus, the U.S. trade balance has suffered due to the economic problems in the Third World, which have damaged U.S. export opportunities, and due to the slow growth in other industrial countries, which has made the United States the major market for developing country exports. Of these two effects, the decrease in U.S. export opportunities has been more significant than the surge of imports into the United States.

The differences in growth rates, however, do not fully explain the fall of U.S. exports. The Third World debt has been the other major factor. Since Third World growth rates on average rebounded to a higher rate in 1984 than did growth rates in European industrial countries, one should have expected that U.S. exports to the Third World would have increased at a faster rate than exports to Europe in 1984. However, this was not the case, due to the Third World debt. Despite the recovery experienced by the Third World in 1984, U.S. exports to developing countries did not recover as fast as U.S. exports to other countries. In 1984, U.S. exports to developing countries rose 2.6% from the 1983 level (a slight fall if measured in constant dollar terms). Exports to the rest of the world rose 12.3% from 1983 to 1984.

U.S. exports to the developing countries also declined more than other exports during the four-year period 1980 to 1984. In that period, U.S. exports to the Third World fell 22.0% in real terms, while exports to the rest of the world fell by 11.7%. Further, U.S. exports to debt-strapped Latin America have fallen 34.4%. Even more to the point, U.S. exports to 21 developing countries heavily burdened with debt have fallen 31.3% in real terms.

Trade and growth figures seem to confirm that the Third World debt has had a major impact on U.S. exports. This should not surprise us, since six major

Latin American debtor countries have reduced total imports from the world by 33.5% during the 1980-1984 period.

The deficit is primarily caused by the recession abroad and the debt crisis in the Third World. These international problems have damaged U.S. export industries and service industries related to those export industries. If the U.S. is going to alleviate its trade deficit problem at all, it will have to deal with the export problem. The import "surge," as it is often called, is not the problem.

SECTORAL COSTS OF U.S. EXPORT PERFORMANCE

The decline of U.S. exports to developing countries in the period 1980 to 1984 has had a significant impact upon employment in the United States. The first thing to be sacrificed by a country when it is forced to take austerity measures is spending on luxury items. The second is spending on heavy capital goods--especially the big ticket items such as aircraft, railroads, cars, trucks, construction machinery, and machine-tools. These are the sectors of the U.S. economy which have suffered the most due to Third World recession and debt.

In 1984, the United States had 560,000 fewer jobs due to the decline of exports to the Third World since 1980. Additionally, another 800,000 jobs have been lost which would have been created if the growth trend of the 1970s had continued after 1980. Thus, nearly 1.4 million U.S. jobs have been lost due to the recent recession in the Third World. Adding up the losses each year since 1980, the poor performance of U.S. exports to the developing countries has cost a total of 3.2 million person-years of employment--an average of 8.4 percent of official unemployment during that period.

Of the 560,000 jobs that do not exist today which existed in 1980, 500,000 are due to the fall of non-agricultural exports. Nearly 300,000 of those are due to the machine and transport equipment export decline. More than half of the jobs lost came from the sector that supplies 41% of U.S. exports to the world and 40% of U.S. exports to the Third World.

The second major sector to suffer is that of manufactured goods classified by materials. About 125,000 jobs were lost due to the lost exports from this sector to developing countries.

We at the Overseas Development Council have conducted a detailed study of these two manufacturing sectors to find out which industries within those sectors were hurt most and which industries did well. Out of a little over one hundred export industries--classified as important either in terms of overall U.S. exports or in terms of the developing-country share of U.S. exports in the industry--over 80% suffered export declines from the 1980 level. Generally, it has been aircraft, motor vehicles, transportation equipment and power-generating equipment which have been damaged the most. The success stories are relatively limited--often industries related to electronic computers and office machines.

Some examples of the change in U.S. exports and related employment are listed below:

INDUSTRY	Real Change of Exports(%)	Estimated Change in Employment
Airplanes	-62	-69,300
Lifting, loading and conveying machines	-76	-23,500
Construction and mining machinery	-76	-23,000
Trucks (except truck tractors)	-73	-19,900
Parts of construction and mining machinery	-26	-16,500

Tractors, tracklaying type	-81	-10,800
Finished iron and steel structures and parts	-65	-10,000
Wheel-type tractors	-74	- 9,300
Air-conditioning machines	-55	- 9,200
Parts & accessories of tractors and motor vehicles	-15	- 9,000
Ferrite cores and other parts for computers and data processing machines	+101	+21,000
Piezoelectrical crystals and related parts	+31	+20,600
Parts of aircraft and spacecraft	+33	+13,100
Telecommunications and sound recording apparatus and equipment	+41	+ 8,000
Integrated circuits	+184	+ 7,400
Peripheral equipment for automated data processing equipment	+34	+ 4,200
Insulated electrical conductors	+72	+ 4,100
Complete digital central processing units	+74	+ 3,800
Complete digital data processing machines	+70	+ 2,800
Engines for aircraft, missiles and rockets	+56	+ 2,600

Even in the cases where U.S. exports to developing countries have risen from 1980 levels, in most cases U.S. exports to the rest of the world increased faster. While the electronic computer sector exports to the Third World added 10,000 jobs, exports to the rest of the world added 34,000 jobs. Exports of office machines to developing countries added 30,000 jobs, while exports to the rest of the world added 84,000 jobs.

Further, in some cases where U.S. export sectors lost jobs due to declines in exports to the Third World, exports to the rest of the world actually increased. Whereas the United States lost 42,000 jobs due to the fall of exports of power-generating machinery to developing countries, the United States gained 23,000 jobs due to exports elsewhere. Declines in exports of transport equipment to the Third World cost 143,000 jobs, while there was a gain of 40,000 jobs due to increases in exports to the rest of the world.

This phenomenon is caused by both a more severe decline of exports to the Third World in the 1980 to 1983 period and a weaker recovery in 1984. The weaker recovery of U.S. exports to developing countries in 1984 was particularly acute in the machine and transport equipment sector, where real exports fell in 1984 by one percent while real exports of these products to the world increased by 5.4%.

SOLUTIONS

The major problem underlying most of the bills aimed at solving the U.S. trade imbalance which are currently before Congress is that they attack the symptoms rather than the root causes of the trade deficit. Where the debt crisis has forced a country to compress imports, we should be looking for ways of alleviating the debt crisis, not punishing the country for its need to export more than it imports. Where the overvalued dollar has made import prices cheap, we should be trying to correct the exchange rate, not levying a surcharge to raise the import price faced by our consumers. Where we find genuine obstructions to the sale of our exports, we should be negotiating freer access for our exports, not retaliating against the imports--which have very little to do with our export competitiveness.

In fact, the trade deficit itself is only a symptom--an indicator that our export performance is lagging behind our growth. As this is due to a great extent, to the slow growth and debt problems in the Third World, it is high time we conceived of policies aimed at dealing with these problems.

The fact is that the U.S. economy cannot withstand such poor export performance in the Third World much longer. If the U.S. economy enters another recession soon, as has been forecasted, our industries will face slack demand in

both overseas and domestic markets. It is vital to U.S. industry and employment that the developing countries have an opportunity to grow quickly and import more goods from us. With the current debt burden, the Third World cannot be expected to buy many more of U.S. exports than it does now.

I offer six broad policy objectives which are important elements of a solution to U.S. trade problems. I draw most of these recommendations from books published in the recent year in ODC's U.S.-Third World Policy Perspectives series.

1. Wider Distribution of World Economic Growth. As it is now becoming clear that the U.S. recovery did not bring along the rest of the world at the same pace, it is important to make every effort to facilitate faster growth abroad. A significant thing that the United States can do is to bring down interest rates to stimulate investment abroad. Secondly, the U.S. government needs to accept the use of expansionary government spending by other countries.

2. Debt Relief. The widespread ramifications of the Third World debt crisis cannot be ignored. It is time to treat the debt problem as the long-term development problem that it is. Most developing countries are incapable of sustaining for a long period of time the present flow of capital resources back to industrial-country lenders. This transfer of resources away from the Third World has already had a grave impact upon U.S. industries. Banks themselves risk outright default on their loans if they insist upon complete and immediate repayment. So far both banks and governments have sought creative approaches to the debt crisis. But the crisis is not over--and will not be over soon under present conditions. In the short-term, U.S. and world economic growth hang in the balance. Without debt relief, these countries will not be able to expand their capacity to import.

3. Larger Role for Multilateral Institutions. Given the current lending trends in the commercial sector, the multilateral institutions have taken a central role in debt crisis. Yet, the resources of these institutions are sorely inadequate to meet the problems arising from the lending contraction. Further, the IMF, in particular, must be willing to extend the time-horizon of its adjustment programs in developing countries. If the Fund can shift its emphasis from the suppression of demand towards a focus on growth and investment, the programs would have more chance of success and a more positive effect on world trade and growth. The World Bank has begun to use its guarantee authority to help the Third World gain access to more finance--this should expand as well.

4. Trade Liberalization and a New Trade Round. A contributing factor to the import-suppression by developing countries has been the growth of trade restrictions in industrial countries during recent years. Many countries have tried to meet the problems of recession and recovery with protectionist measures. This has had a particularly negative effect on the Third World. Because of the debt, developing countries have had to run trade surpluses. Yet, protectionist measures have made this more difficult to do. The Third World response has been to restrict imports to make up for restricted export markets. This, of course, has a chain-reaction effect which has contributed to the downward spiral of world trade. Many calls have been issued for trade liberalization, but few actions can be taken in the present atmosphere of mistrust. A new round of trade negotiations would provide right conditions for mutual commitments to liberalize trade on a global level. Without the round, governments are likely to resort to threats instead of compromise.

5. Domestic Adjustment. Some U.S. industries, even if there had not been a recession, debt crisis, overvalued dollar, or protectionism, are not now competitive internationally. It is a fact of economic life, that there will be dynamic industries and declining or aging industries. One way to help developing countries in their efforts to find a viable niche in the international economy is for the industrial countries to avoid protecting declining industries. In the long run, such protection will only hurt the U.S. economy more than the protected industry gains. Obviously, the declining industry will resist adjusting to the new economic realities which may require it to cut back production. Here is where the U.S. Congress can help facilitate the process of adjustment through aid for retraining and temporary adjustment assistance to the industry involved. Without such adjustment, the more competitive companies--some of which are in the Third World--will be excluded from the U.S. market. Here again, the Third World can only respond by restricting imports from its trade partners. In most cases, the costs to the U.S. export sector is higher than the gain by the industry which is protected.

6. Reduce the U.S. Budget Deficit. Lastly, but perhaps the one objective over which Congress has the most control, the budget deficit must be reduced. The fiscal imbalance has been raising real interest rates and the value of the dollar for some time now. For both Third World debt servicing and for U.S. export trade, a reduction in real interest rates and the value of the dollar would be a tremendous aid. The best way to achieve this is by reducing the U.S. budget deficit.

Chairman LAFALCE. Thank you very much for your excellent presentation, Mr. Tucker.

We will question you upon the conclusion of the remarks of the other panelists.

I am pleased that Mr. Mayer is here. I understand the plane was delayed a bit.

Mr. MAYER. I got to La Guardia at 7:15 and I got here at 10 minutes to 10. I am sorry. [Laughter.]

Chairman LAFALCE. We have all had similar experiences.

We will now call upon Dr. Raul Prebisch for his testimony.

STATEMENT OF RAUL PREBISCH, UNITED NATIONS ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN

Mr. PREBISCH. Thank you, Mr. Chairman, for inviting me to present my views on this problem.

In my long experience, Mr. Chairman, I never have seen such a difficult and serious situation in Latin America as now. I have seen the world depression as not so complex and difficult as the present situation.

Because there were certain changes in society and large masses of the population in industry in the cities, the concentration of population there, there was a growing conscientiousness about the evils of the situation that did not exist before. So that from the social, economic, and political point of view of this situation in Latin America is much more difficult and unpredictable, if things continue as they are.

Up to recent months we were told be patient, interest rates and the rate of growth of the developed countries would improve, and you will be able to pay without difficulties your debt services. That has not happened, and I don't think that there are many people or many economists that believe that this improvement will happen very soon.

On the other hand, we continue to see projections showing that if imports are reduced by such and such percent, we will have a surplus and be able to pay the debts. Well, yes, these predictions are correct from the mathematical point of view, but attention is not paid to the consequences of a further reduction of imports. That means a further reduction of the rate of growth, and a further increase in unemployment and social tensions.

Up to now emergency solutions have been followed. That was all right, but how far can we continue in Latin American countries to increase our debt in order to pay the services? We used part of our internal resources and external resources to pay part of the debt and the other part has been translated into a growing amount of debts. And the situation, in my view, from every point of view is unsustainable.

I don't think that this is fundamentally a problem between banks and debtors. In my view, it is a political problem. It is a highly political problem, first, due to the fact that private banks that were not used to this type of lending operations, except for short term, have been tempted by the abundance of resources in the Eurodollar market to lend to developing countries without any foresight at all.

I have no admiration at all for the way in which the commercial banking community has proceeded. I do not have admiration for the lack of responsibility of developing countries who, with a few exceptions, have indulged in such borrowing operations without considering first the objective of this borrowing and, second, the possibilities of pay.

So that in my view there was a convergence of irresponsibilities from the creditors and debtors, and we now are following the consequences of this.

There was no regulation for this lending operation of the Euro-dollar market. From a long time ago, internally, the creation of money was subject to certain principles and to certain supervision and to certain regulations. Nothing of that kind has happened in the Eurodollar market, nothing of this kind or any attempt to regulate by the very powerful interests of the banking community that made extraordinary profits in the lending operations, and now they are reluctant to adjust. They are asking for a very drastic adjustment on our economy, but they are not willing to adjust in a minor way, except when consequences have forced them to do so.

I for one, Mr. Chairman, consider that we should make a very, very great effort to continue to pay the debt, and this is not a new attitude in myself. As an economist and Under Secretary of the Treasury in my country in the early 1930's, I supported the view that we should continue to pay. Argentina was one of the few countries that paid their foreign debt with great sacrifices.

Now my country is taking very heroic measures to stop inflation, and, rightly so, badly needed measures with a great degree of understanding of public opinion.

If the country has to follow what it has been doing in the last few years, I think that the fight against inflation should become more and more difficult. I am afraid that some forces in the country, the political forces, even in the government party would make the situation unsustainable and difficult, very difficult.

What to do? Mr. Chairman, I have been thinking and have several suggestions, and without making any proposal, I may say that I am inclined to do the following:

First of all, to make a difference between the decision of internal resources today and the transfer of these resources into dollar transfers. I think the country should mobilize and should make the sacrifices in their budget to mobilize internal resources.

Now if there are no possibilities of paying, of transferring this, the only solution that I see is to deposit, to constitute a fund for the untransferred dollars according to a certain schedule and devote these funds for investment in the Third World countries according to negotiations between banks and governments inside the framework of the political arrangements.

I do not think that governments have to negotiate, but governments should establish a framework in order to alleviate the situation of developing countries.

There are other solutions, but some amount of losses are unavoidable, Mr. Chairman, and let us not make any illusion about this point.

We need burden sharing. The burden that has fallen on developing countries is a very heavy contraction of the economy and sacri-

fices to transfer in a situation where exports have been declining, in terms of trade have been declining and interest rates have gone up. The burden falling on developing countries has been indeed very, very heavy.

So we need some burden sharing. The banks have to follow and have to suffer the loss because, if interest is reduced on long-term and the debt is extended, the loss is unavoidable. And who will pay the losses is another matter, but we shouldn't fall into illusions any more in this matter. I think that it is necessary to take this with great energy and having it in mind what you have said, Mr. Chairman.

You have given very impressive figures about the proportion of the debt, the services of the debt on exports, and we need a realistic appraisal and realistic solution of the problem.

I am wondering, Mr. Chairman, what historians in the next 50 years will say by describing this situation. It is hard to imagine. Such a simple program of extending the debt, the maturities, and lowering the rate of interest has been spoiling, not only the economic relations, but the political relations between Latin America and the United States. I am more and more concerned about that because many, many factors are brewing. Advice is given not to pay, very powerful advice, and we think that things will be solved by themselves. That is not true, Mr. Chairman.

Thank you.

[The prepared statement of Dr. Prebisch follows:]

EXTERNAL DEBT OF LATIN AMERICAN COUNTRIES

Statement by Dr. Raul Prebisch before the U.S. House Committee on Banking, Finance, and Urban Affairs - Subcommittee on Economic Stabilization, on July 25, 1985.

THE EXTERNAL DEBT OF LATIN AMERICAN COUNTRIES

Raúl Prebisch

A short time ago, the view was frequently held that the worst was over in relation to the external debt of developing countries: interest rates would fall and a revival of trade could be seen around the corner.

I do not know what is going to happen in the future. But who can believe in the probability of much lower rates in the presence of the current US budget deficit? Who can expect an intense revival of trade in developing countries under the present conditions of the great industrial centres?

Meanwhile, debtor countries have had to recourse to emergency solutions. The high burden of interest has been paid partly with an increase of the debt and partly by the external surplus obtained through a drastic cut in imports.

Some projections have been made showing that developing countries should compress their imports in order to obtain an external surplus, but generally the very serious internal consequences are ignored. Indeed, developing countries have to

follow a policy of growth to counteract the effects of years of low rates of development or stagnation. So, even if external conditions were to improve, the first priority should be a higher rate of growth.

We should not forget that import restrictions were superimposed to the adverse effects of the fall of exports and the deterioration of the terms of trade. All this, together, was responsible for the intense contraction of economic activities resulting in great unemployment and disguised unemployment. As a consequence, chronic inflation has been considerably aggravated.

I am far from sustaining the view that inflation is caused mainly by foreign factors. It is fundamentally an internal problem. But I have no doubt that the payment of the services of the debt is a factor that weighs heavily against the success of an anti-inflationary policy.

Take the case of Argentina. Very drastic measures have been taken recently in order to prevent the imminent risk of hyperinflation. This is in itself very difficult, but the lack of a proper solution to the debt problem is seriously jeopardizing the success of the plan. Social and political stability are at stake.

However, up to now I cannot see any symptoms of a fundamental change of attitude on the part of the creditor countries. And I am extremely concerned by the internal effects as well as the adverse impact on our relations with developed countries, mainly with the United States.

This is basically a political problem in its origin and development. Short-term lending operations by important banks using the resources of the Eurodollar market have not been subject to any regulation whatsoever, notwithstanding the recognition that this regulation is indeed indispensable in internal banking activities. On the other hand, developing countries fell easily into the temptation to borrow lavishly without a clear sense of responsibility.

I do not in any way mean that negotiations have to be transferred to governments. Nonetheless, I consider that the latter should establish a framework within which these negotiations should be held.

Several suggestions have been offered. But there are no magic solutions. And both debtors and creditors should have to share in the burden. The share of the former has been already

very high due to the contraction of their economies, while the latter have not suffered except in a few cases. Any deliberate reduction in interest rates would inevitably be detrimental to banks, and the extension of maturities for once would deprive them of commissions and charges that are rather high.

But I do not see how this could be avoided. I have always in mind the wise solution of the New York City debt problem a few years ago: a foresighted solution for all parties concerned.

The moment has arrived to enter decisively into a new stage. Our countries have been reluctant to form a debtors' club and rightly so. But the situation seems to me unsustainable. I am afraid that sooner or later unilateral measures may be taken if nothing is done and already some countries have had to do this in a temporary fashion.

This would be highly regrettable from every point of view, except perhaps from the point of view of some short-term political interest. Parenthetically, I would like to recall that at the beginning of the thirties, as a young Under-Secretary of Finance, I strongly advocated the full payment of

the debt. Argentina was one of the few debtor countries that continued to do so with great sacrifices. I do not think that this could be repeated under the present difficult circumstances, if a proper solution is not available.

Several ideas are in the air. I feel myself rather inclined towards the idea that debtor countries pay the full amount of interest charges but transfer only a part of it and deposit the other part into a fund to be used for investment purposes under conditions agreed upon by both parties, taking into consideration the foreign constraint to development. I consider this a very constructive way out of the present serious situation.

This is not the only matter of concern to me. Your country, as well as ours, is losing a great opportunity to build new relationships with a long-term vision. We should not repeat the errors of the past. Many mistakes have been made on both sides. An objective appraisal has to be made. Time is getting short. Let us begin a frank discussion.

Mr. PREBISCH. Mr. Chairman, I am under the effect of the jet lag. I am a little deaf, and if you will speak loudly, I will appreciate it very much.

Chairman LAFALCE. I will attempt to speak more loudly.

Our next witness will be the author of many, many books on subjects that are closely related to this, such as "The Bankers," "The Fate of the Dollar," "The Money Bazaars," et cetera, Martin Mayer.

**STATEMENT OF MARTIN MAYER, AUTHOR, "THE BANKERS" AND
"THE MONEY BAZAARS"**

Mr. MAYER. Thank you, Mr. Chairman.

I am sorry to be late. I have browsed the prepared statements here, hopefully to my profit. I have no major substantive disagreements with what has been said before. I have some disagreements in detail.

It seems to me that there is perhaps a value in going over perhaps a little more fundamentally what happened to put us in the present situation and the basic statement which is in my statement here, too, which is that eventually this is going to have to be negotiated out and sooner is better than later.

As matters now stand, the borrowers are all taking their lumps, and the banks are just beginning to make realistic provisions for the losses that lie ahead for the governments of the developed countries, which to some extent set the banks up.

I mean I am not a defender of what the banks did, but I was close enough to some of these situations to know that there was a great deal of urging from the Government of the United States with reference both to Latin America and Africa, from the governments of the West European countries with reference to East European debt and Latin America, also, to some extent. Very few of them got too closely involved with Africa unless they had government guarantees around it that they should come and fill in what wasn't being done by others.

But what happened to all of us on both sides of this began with the immense inflation in commodity prices in the early 1970's, which happened before the first oil shock, which nobody seems to remember these days. Oil began by playing catch up. In that context then, you could say that you had seen a reversal of the deteriorating terms of trade that the less developed countries had experienced since the end of the Korean war; and that, therefore, they could indeed carry greater debt burdens than they then had; and, therefore, it was OK for the banks to be urged to do this, and it was OK for the banks to do it quite apart from greed factors.

We had together with that the general inflation of this period, which meant that fixed indebtedness became a declining burden and that nominal income rose rapidly. For much of that period interest rates were actually below inflation rates, and the price of the dollar in terms of other currencies kept declining, which multiplied the apparent rewards to those who borrowed dollars.

Then there was a fourth belief in the developing countries, which I lay partly at Dr. Prebisch's door, that they would be better off

financing their development with officially borrowed funds and with direct investment by multinational companies.

It is worth looking back to the 1960's and 1970's and to the crusade against the multinational companies that was conducted through the aegis of the United Nations, which has only recently begun to sort of die away. The United Nations being a dinosaur, it takes a long time for the head to find out what has been going on down around the tail.

Much of the crusade against the multinational companies was quite reasonably motivated. They were often arrogant and rapacious, they interfered in local political life in disgraceful ways, and they cheated their hosts with transfer pricing.

Nevertheless, they had a self-interest which the banks essentially do not have in the progress of the countries in which they were making investments, and the guy who has an investment in your country is going to be more helpful in tough times than the guy who simply has a loan and can say you pay it, which is what happened.

Moreover, with the growth of borrowing by the state and state agencies, economic decisionmaking became increasingly concentrated in bureaucracies that were ill-equipped for the purpose. In many countries were the servants of a kleptocracy, a rule of thieves.

It is commonplace that the net position of Argentina and its nationals is not far off balance because the assets held by Argentines in foreign places are within shouting distance of the debt Argentina owes, but Argentina has no access to that money.

In Mexico, too, what is gently known as capital flight dissipated much of the immense borrowing to which the national credit was pledged and now wastes the hard-won trade surpluses. Brazil is in a better case because Brazilians invest at home.

The banks are enormously to blame here also because they knew. They were the people who were arranging the transfer of money out at the same time that they were lending the money in. It is completely outrageous behavior on the part of very many people, both the lenders and the borrowers.

They were in effect, one could almost say, letting the Argentine private sector, which was exporting the money funds alone that were being made to the official Argentine Government agencies, many of which, particularly the military ones were wasting the money quite remarkably.

Moreover, all the LDC's, and especially the Africans, who had less expertise of their own to interpose, have been victimized by bad advice from the universities and bad advice from the international institutions.

With few exceptions, the investments they made with the money they borrowed do not, will not and should not have been expected to generate the income streams required to service the debt.

I am not a great fan of Milton Friedman, and there is no question in my mind that governments must provide an infrastructure which is expensive and which does not come automatically and which the private sector will not do. They must also provide what Milton Katz and his book on the Marshall plan called a legal order, which is a very useful way of looking at the world, and that, too, in a sense costs money and involves certain political and cultural

changes if you are talking about economic development, which you must be prepared to undergo and which too many of these countries have not been prepared to undergo, particularly since it was possible for them to continue to move ahead by borrowing.

And, finally, of course, the banks were funded to lend by the extraordinary success of the oil exporters. Once they had bought back the ownership of their oil fields, they had no immediate use for the immense surpluses they were earning. They were quite unwilling to lend in quantity themselves to the LDC's or to make any considerable direct investments anywhere outside the United States and Northern Europe, and of course they still are, but they were prepared to become creditors of the great banks, which would in turn supply the funds to sovereign borrowers.

Interest rates remained below the rate of inflation partly because of what was then incessant pressure from politicians on the monetary authorities to keep rates down, but mostly because the banks were awash in money from the Arabs.

It is obvious now that they could have refused the deposits or dealt with them as the Swiss have always dealt with foreign money, charging for its custody rather than paying interest. But to say the least, it was not obvious then. In fact, every agency of government that was associated with this process was leaning on the banks to do the petrodollar recycling.

A danger was recognized in the fact that much of the borrowing by the oil importers went out the exhaust pipe instead of into the ground for investment, but those were the days when inflation would reduce the real burden of the principal, and commodity prices, remember, would go to the sky. Anyway, sovereigns didn't go broke.

This, incidentally, was the worst error made perhaps in all of these analytical exercises. I have had occasion to say elsewhere the definition of sovereign lending is that there is nobody whose kneecaps you can break.

The worst problem in some ways for the banks was that the flow of funds from the oil producers seemed predictable. Banks fell into the notion that they could make long-term plans in what is fundamentally a short-term business and always was and, indeed, was recognized as such in the legislation creating national banks in this country, and it wasn't changed until the 1920's.

So that they developed quotas of loans that they were going to make to different kinds of borrowers and you filled out that quota whether, in fact, it made sense or not. When things began to look tense in the early 1980's, there was a sniggering wisdom from Keynes' aphorism about how the lender is at the mercy of the really big borrower.

You can try that one out today on a Mexican peasant or a Brazilian factory worker or indeed on an American manufacturer who used to export to Latin America and can't find a bank now to write the trade credits.

There isn't going to be a major resumption of that kind of lending either for development let alone and certainly not for balance of payments purposes in our time. This conclusion is firmly buttressed by the visible intention of the United States to absorb the whole of the world's ready credit to pay for that portion of our

bloated appetites that we do not meet with our own production and to fund the disgraceful domestic deficit.

We are now behaving, of course, very much like our feckless Latin neighbors who borrowed because that was the easy way to pay the bills. In our defense I suppose we could say that the Swedes and the Danes, our colleagues at the top of the income heap, and impeccably welfare oriented, the best friends of the Third World, are doing much the same, but it is still a disgrace.

Under these circumstances U.S. banks will, of course, pull in money from abroad to lend here rather than look for external loan possibilities and other lenders will also put their money into the country where they print the dollars, rather than into a country which has to scramble to earn dollars.

This situation will persist, to quote Mr. Stockman, as far as the eye can see. Latin children are the losers now, and our children's children will be the losers later. What should be done is a question with a different answer in each country.

Argentina can handle its debts only if the Government can persuade the rich and upper-middle-class to repatriate some of their overseas holdings. President Alfonsín appears to be giving this his best shot, and while the odds would seem to this observer to be against him, we can hold our breath a little longer. I have much sympathy with what Vice Chairman Martin said recently, but because he said it during the week when Alfonsín first put his feet on this high wire, Volcker was doubtless right to rebuke him.

Mexico is backsliding, relying as cynically as her bankers on the presumption that when push comes to shove the United States will somehow pay Mexico's bills.

Bolivia and Peru, Zaire and Sudan, Poland and Nicaragua obviously could be written off now and certainly should be covered at least 50 percent in the loan loss reserve.

Brazil, on the other hand, still seems to me a good bet over the long haul because it remains, though Brazilians now make fun of the line, a land of opportunity.

Thus said, a net transfer of real resources from debtor to creditor nations in the present world situation is intolerable, and ways of freeing up money for development must be found.

By far the most important steps to be taken are in the political life of these countries themselves, which must find a way to shut off political and military leaders who consider the State and the economy to be their servants and to find leaders who consider themselves the servants of their societies.

To put the matter bluntly, command economies cannot work in the LDC's, and market economies can. These societies, like others, respond more efficiently and more effectively to price signals than to political exhortation and to repression.

If you are not prepared to accept market corrections of unwise policies, you cannot lead an LDC to economic success. Your good luck will go to waste and monuments, and your bad luck will turn to catastrophe. Ask Julius Nyrere.

One corollary is that direct investment must be sought, welcomed and to a degree protected rather than resented, controlled and constantly menaced. Such a climate will encourage local investment, too.

Creditors now must face up to the legitimacy of the losses they incurred by foolish lending, especially 1979 to 1981, and reduce the burden on the debtors.

The governments and central banks in the developed countries must facilitate this reduction and pick up some of the costs perhaps through the Tax Code. I note the fact that the IRS penalizes the erection of loan loss reserves now, which is foolish, but at the same time the regulators commit loan loss reserves to be regarded by the banks as a mickey-mouse enhancement of reported capital, which is disgraceful accounting.

So long as the Fed, the Comptroller and the FDIC, through regulatory accounting procedures, which differ from generally accepted accounting procedures, permit banks to treat loan loss reserves as simply a form of surplus, you cannot really seriously ask the Internal Revenue Service to permit such losses to be gained from pretax earnings.

A few modest steps it seems to me can be taken legislatively. As Karin Lissakers pointed out to the Joint Economic Committee a few weeks ago, there are projects ready to roll in many Latin countries that are now held up by these countries' inability under IMF agreements to provide the local counterpart funds. Removing the requirement for counterpart funds would not cost anybody anything and would help turn some wheels that now stand idle.

In general, the IMF and the U.S. Treasury should realize the extent to which a trade surplus is inflationary. People are being paid to make things that they cannot buy, just as a trade deficit like our own helps hold prices down.

To insist on a simultaneous increase in trade surplus, decrease in inflation and reduction in government deficit is to lock the brakes on an economy.

Here again let it be noted, the prescriptions should be different from country to country. Argentina has to accept some years of economic stagnation to create a stable currency Argentines might be willing to accept as their store of value, while Brazil can flourish with much higher inflation.

Mexico must liberalize its economy and political system, clear out the corruption and learn to dislike incompetence. We have a lot on our plate at home and great sins to atone for, but governmentally we must lose some of our reluctance to play God with these debtors, for debtors, like children, not only have to take orders, but they need orders. This is why it is a bad idea to become a debtor.

Casting forward the shadow of the Continental-Illinois debacle, it is a lesson we will be learning from the other side ourselves in the years to come.

Thank you.

[The prepared statement of Mr. Mayer follows:]

STATEMENT OF MARTIN MAYER TO THE SUBCOMMITTEE ON ECONOMIC
STABILIZATION, July 25, 1985:

My name is Martin Mayer, and I write about a number of subjects, including several closely related to these hearings. Since 1975, I have written extensively about financial matters, including five books--The Bankers; Conflicts of Interest; The Broker-Dealer Nexus; The Builders (a book about housing); The Fate of the Dollar; and The Money Bazaars. In 1981-82, I was a member of President Reagan's Commission on Housing. I have had one other experience in the federal government, in 1962-67, when I was a member of President Kennedy's and President Johnson's Panel on Educational Research and Development.

I have already written and said in various fora, including the Senate Banking Committee in 1983, that I believe that much of the lending to the LDCs in the middle and late 1970s and early 1980s, and especially the lending to Latin America, was improvident on both sides, and that there remain significant losses to be divided among the borrowers, the banks, and the national budgets of the developed countries.

Ever since the Fed helped Pollyanna from the side of the road, where the Mexican default had left her dusty and breathless, we have been hearing that it is going to work out all right. Steady 4% growth in the OECD countries would enable the Latins and even the Africans to handle even 15% interest rates. Now the reduced rates will, we are told, more than compensate for the loss of export markets as the U.S. and probably the EC slow down. No way. Eventually, and I still think sooner is better than later, this thing is going to have to be negotiated out. As matters stand now, the borrowers

are taking their lumps, the banks are beginning--just beginning--to make realistic provisions for the losses that lie ahead, and the governments of the developed countries are still ducking their responsibilities. This is not sustainable.

Various factors created the outburst of bank lending to LDCs, and one cannot gain a useful view of what is likely to happen next without understanding those factors. They are, in no particular order:

1) the immense inflation in commodity prices in the early 1970s (preceding the first oil shock). This seemed to imply a reversal of the secular trend in the terms of trade, which had run since the early 1950s against producers of primary commodities and for producers of manufactured goods. Under these circumstances, the income stream projected for commodity producing countries could support considerably more debt service than previously believed. In this context, the oil price increases were seen as confirmation of the reversal in the trend, rather than as an exaction that would, in effect, reduce the fund from which all commodities were bought and thus force reduction in the prices of the others.

It should be noted that the apparent decline in the productivity of other factors in the period 1975-85 can be explained by the great increase in the productivity of each unit of energy, an input which by the 1970s had become every bit as central as land, labor and capital. Real rents, real wages and real returns on investment all declined or rose at a greatly reduced rate in that decade, while the world worked at energy efficiency. Borrowings had to be serviced from rents, wages and earnings--but only, of course, from nominal rents and wages and earnings. Hence the importance of

2) the general inflation of this period, which meant that fixed indebtedness became a declining burden, and nominal incomes rose rapidly. For much of the period, interest rates were actually below inflation rates, and the price of the dollar in terms of other currencies kept declining, multiplying the apparent rewards to those who borrowed dollars. Those who projected continuation of this condition assumed that the United States would be willing to sustain forever the social pain of escalating inflation. It was not.

3) a false belief in the developing countries, with which I fear Dr. Prebisch is closely associated, that they would be better off financing their development with officially borrowed funds than with direct investment by multinational companies. There is no intention here to defend the behavior of the multinational companies, which were often arrogant and rapacious, interfered in local political life in disgraceful ways, and cheated their hosts with transfer pricing. Still, their self-interest dictated considerable transfer of technology and training to foreign parts, they were in significant ways allied to their hosts because they did better if the hosts did better--and in the end the local sovereign did have a final say and thus real bargaining power. Not the least of the reasons for despair about the future of Africa is that one still hears so much of the sloganeering of the 1960s from most African leaders.

With the growth of borrowing by the state and state agencies, economic decision-making became increasingly concentrated in bureaucracies that were ill-equipped for the purpose and in many countries were the servants of a kleptocracy, a rule of thieves. It is commonplace that the net position of Argentina and its nationals is fairly close to balance, because the assets held by Argentines

in foreign places are within shouting distance of the debt Argentina owes--but Argentina has no access to that money. In Mexico, too, what is gently known as "capital flight" dissipated much of the immense borrowing to which the national credit was pledged--and now wastes the hard-won trade surpluses. Brazil is in much better case, because Brazilians whatever their failings invest at home.

Moreover, all the LDCs, and especially the Africans, who had less expertise of their own to interpose, have been victimized by bad advice from the universities and the international institutions. With few exceptions, the investments they made with the money they borrowed do not, will not and should not have been expected to generate the income streams required to service the debt. Without adopting the rest of Milton Friedman, and conceding cheerfully that governments must provide an infrastructure and what Milton Katz called a "legal order" in his memoirs of the Marshall Plan, one can safely say that people betting with their own money are likely to make more productive investment decisions than governments, especially modern governments with time horizons so low you can't see them from ground level.

4) finally, the banks were funded to lend by the extraordinary success of the oil exporters. Once they had bought back the ownership of their oil fields, they had no immediate use for the immense surpluses they were earning. They were quite unwilling to lend in quantity to the LDCs, or to make any considerable direct investments anywhere outside the United States and northern Europe, but they were prepared to become creditors of the great banks, which would in turn supply the funds to sovereign borrowers. Interest rates remained below the rate of inflation partly because of what was then

incessant pressure from politicians on the monetary authorities to keep rates down, but mostly because the banks were awash in money from the Arabs. It is obvious now that they could have refused the deposits--or dealt with them as the Swiss deal with foreign money, charging for its custody rather than paying interest--but to say the least it was not obvious then.

Worse: the flow of funds from the oil producers seemed to be predictable, and the big banks began to believe that they could make long-range plans like other businesses--something that clearly had not been possible in earlier times, when everyone understood that banks were inescapably short-term institutions. These plans of the giant banks included petrodollar recycling. A danger was recognized in the fact that much of the borrowing by the oil importers went out the exhaust pipe instead of into the ground for investment, but those were the days when inflation would reduce the real burden of the principal and commodity prices would go to the sky. Anyway, sovereigns didn't go broke. (This, incidentally, was the worst error: as I have had occasion to say elsewhere, the definition of sovereign lending is that there is nobody whose kneecaps you can break.) When things began to look tense in the early 1980s, there was a sniggering wisdom from Keynes's aphorism about how the lender is at the mercy of the really big borrower. Try that one out today on a Mexican peasant or a Brazilian factory worker or indeed on an American manufacturer who used to export to Latin America and can't find a bank to write the trade credits.

Looking ahead, it is quite certain that none of these four factors will recur, at least in the foreseeable future. Thus there will not be a major resumption of lending by banks for development

purposes, let alone balance-of-payments purposes, in our time. This conclusion is firmly buttressed by the visible intention of the United States to absorb the whole of the world's ready credit to pay for that portion of our bloated appetites that we do not meet with our own production, and to fund the disgraceful domestic deficit. We are now behaving, of course, very much like our feckless Latin neighbors who borrowed because that was the easy way to pay the bills. (In our defense, I suppose we could say that the Swedes and the Danes, our colleagues at the top of the income heap, and impeccably welfare-oriented, friends of the Third World, are doing much the same.)

Under these circumstances, U.S. banks will of course pull in money from abroad to lend here rather than look for external loan possibilities, and other lenders will also put their money into the country were they print the dollars rather than into a country which has to scramble to earn dollars. This situation will persist, to quote Mr. Stockman, "as far as the eye can see." Latin children are losers now, our children's children will be losers later.

What should be done is a question with a different answer in each country. Argentina can handle its debts only if the government can persuade the rich and upper-middle-class to repatriate some of their overseas holdings. President Alfonsín appears to be giving this his best shot, and while the odds are heavily against him we can hold our breath a little longer. (I have much sympathy with what Vice-Chairman Martin said, but because he said it during the week when Alfonsín first put his feet on the high wire, Volcker was doubtless right to rebuke him.) Mexico is backsliding, relying as cynically as her bankers on the presumption that when push comes

to shove the United States will somehow pay Mexico's bills. Bolivia and Peru, Zaire and Sudan, Poland and Nicaragua obviously could be written off now, and certainly should be covered at least 50% in the loan loss reserve. Brazil, on the other hand, still seems to me a good bet over the long haul, because it remains, I think, a land of opportunity.

This said, a net transfer of real resources from debtor to creditor nations is intolerable, and ways of freeing up money for development must be found. By far the most important steps to be taken are in the political life of these countries themselves, which must find some way to shuck off political and military leaders who consider the state and the economy to be their servants and to find leaders who consider themselves the servants of their societies. To put the matter bluntly, command economies cannot work in the LDCs, and market economies can. These societies, like others, respond more efficiently to price signals than to political exhortation and repression. If you are not prepared to accept market corrections of unwise policies, you cannot lead an LDC to economic success: your good luck will go to waste and monuments, your bad luck will turn to catastrophe. Ask Mr. Nyrere. One corollary is that direct investment must be sought, welcomed and to a degree protected, rather than resented, controlled and constantly menaced. The climate will encourage local investment, too.

Creditors must face up to the legitimacy of the losses they incurred by foolish lending, especially in 1979-81, and reduce the burdens on the debtors. The governments and central banks in the developed countries must facilitate this reduction and pick up some of the costs, perhaps through the tax code. (In the United States,

for example, IRS should permit unlimited allocation to loan loss reserves from pre-tax earnings; and the regulators in return should demand honest accounting of the loan-loss reserve as a reduction of reported assets rather than as a mickey-mouse enhancement of reported capital: so long as the Fed, the Comptroller and the FDIC permit banks to treat loan loss reserve as simply a form of surplus, IRS of course cannot regard money allocated to such a reserve as tax-deductible.

A few modest steps can be taken legislatively. As Karin Lissakers pointed out to the Joint Economic Committee a few weeks ago, there are projects ready to roll in many Latin countries now held up by their inability under IMF agreements to provide the local counterpart funds. Removing the requirement for counterpart funds would not cost anybody anything, and would help turn some wheels that now stand idle. In general, the IMF and the US Treasury should realize the extent to which a trade surplus is inflationary (people are being paid to make things they cannot buy), just as a trade deficit, like our own, helps hold prices down. To insist on a simultaneous increase in trade surplus, decrease in inflation and reduction in government deficit is to lock the brakes on an economy.

Here again, let it be noted, the prescriptions should be different from country to country. Argentina has to accept some years of economic stagnation to create a stable currency Argentines might be willing to accept as their store of value, while Brazil can flourish with much higher inflation. Mexico must liberalize its economy and political system, clear out the corruption and learn to dislike incompetence. We have a lot on our plate at home, and great sins to atone for, but governmentally we must lose some of our reluctance to play God with our debtors, for debtors like children not only have to take orders but need them. (This is why it's a bad idea to become a debtor.)

Casting forward the shadow of the Continental-Illinois debacle, that's a lesson we will be learning from the other side ourselves, in the years to come.

Chairman LAFALCE. Thank you very much, Mr. Mayer.

Let me start at the very end with the last sentence that you uttered, Mr. Mayer. "Casting forward the shadow of the Continental-Illinois debacle, that is a lesson we will be learning from the other side ourselves in the years to come." Can you expand on what you mean by that?

Mr. MAYER. It was the opinion of the U.S. Treasury, it was my opinion. I think it was fairly clear in the law that the FDIC and the Fed did not, in fact, have the power to bail out the holders of senior debt of the Continental-Illinois holding company of the Continental-Illinois Corp. But the situation was that there was \$17 billion of Eurodeposits in Continental-Illinois. These same people owned the commercial paper that had been issued through the Caribbean—

Chairman LAFALCE. How many billion did you say?

Mr. MAYER. \$17 billion of Eurodeposits in the \$40-odd billion funding of Continental-Illinois of the bank.

There was also a holding company. The holding company had issued a billion dollars' worth of commercial paper through its Caribbean subsidiary. The regulators were given to understand fairly clearly by the holders of that commercial paper, who were the same people as the holders of the deposits in the bank, that if they did not make good on the commercial paper and, indeed, on the other senior debt securities of the holding company that were owned abroad, that that \$17 billion would be yanked from the bank.

It was a matter of great concern. I mean we heard a lot of rhetoric about the collapse of the world banking system and some of that was true, but the immediate problem that the regulators faced in this country was that foreigners had control over what was going to happen to that bank and foreigners were demanding that, whatever our laws might say, we make good the holders of the commercial paper that had been issued by the Continental-Illinois Corp., and they went ahead with it.

You will recall at the time that Don Regan in the Treasury Department said you don't have the authority to do it and threatened to sue. The matter went up to the White House, and they didn't sue finally because everybody panicked.

But the lesson is not the question of how it should have been done or even necessarily what should have been done, just as once upon a time the banks were more or less sovereign in the economy.

When Drysdale went under, Chase said we will lend you guys some money to make up for your losses, and Merrill-Lynch said we control a lot of deposits in your bank, and if you people really insist that you are not liable on Drysdale, then you will have a lot of trouble funding your bank through the various money market funds that now buy your CD's, and Chase backed away.

The U.S. Government backed away in the Continental-Illinois situation. If you are a debtor, you wind up in a situation where people tell you what to do. The United States is moving into that situation; and one of the first hints that this was coming was Continental-Illinois, where the question of what our agencies were legally empowered to do was perhaps tertiary in their discussions as they have been reconstructed for me.

Chairman LAFALCE. Let me pursue that a little bit, and this is a little bit off the subject of this hearing, but a few weeks or so ago we had Dr. Martin Feldstein and Dr. Fred Bergsten testify on the problem of our debtor status as a country. This is the first time we have had debtor status as a country almost since the beginning of World War I.

One estimate was that by January of 1990, if things continue, we might accumulate as much as \$1 trillion in net external debt, and that thereafter this might increase by approximately \$300 billion per annum.

Now some individuals minimize this, but taking your last sentence and your explanation of it, this might put us in an extremely precarious situation, might it not?

Mr. MAYER. Oh, yes. We should have some sympathy with the Argentines, and we should have some sympathy with the other debtors. We are going there ourselves. That was the point of my last sentence.

It would be very serious. The assumption that we can borrow forever looks good today. It may not be so good later on. There is a ceiling on even what the United States can borrow.

Chairman LAFALCE. We may be satiated with foreign dollars to the point where there will be a tremendous withdrawal of those foreign dollars; is that correct?

Mr. MAYER. Withdrawal is a funny phrase. There would be an attempt to transfer the assets to other kinds of holdings at some point. We saw this happening after all in 1978 and 1979 where the Brazilians and the Argentines moved their reserves somewhat from dollars into marks and paid for it later, and all sorts of people were playing the foreign currency markets against the dollar.

There comes a point when you pour certain numbers out into the world. The much more serious thing for us really is that you lose control of your own monetary policy. Up to now, if it has seemed desirable to the Fed to increase domestic interest rates to slow things down, we have been gainers by that internationally because we are net creditors and the international debts are denominated in dollars.

When it comes the next time around and the Fed moves to increase interest rates to slow down the economy and suddenly we are net debtors and our foreign trade situation deteriorates and this becomes a limit on what the Fed can do in the operation of the U.S. money supply and, indeed, in noninflation, and that is just a question of how much you can stimulate.

If we have already lost control of the fiscal policy component on government in the economy in this country—

Chairman LAFALCE. And don't you think we have done that?

Mr. MAYER. Oh, yes, and we are about to lose monetary policy, too. That is a very nasty future that is being built here.

Chairman LAFALCE. I think most people are coming to understand that we have lost the ability to resort to fiscal policy as a tool to deal with our future economic difficulties.

Mr. MAYER. Temporarily one hopes.

Chairman LAFALCE. Temporarily if we can deal with the structural deficit, but if we don't deal with that structural deficit in a very meaningful way, then we can't resort to fiscal policy. But I

don't think that we have yet had enough data presented to the Congress or arguments presented to the Congress to enable us to understand how we might be losing the ability to resort to monetary policy as a tool to deal with our future fiscal difficulties. So I would like you to expand upon that a bit more.

Mr. MAYER. The Latin Americans really can give you chapter and verse on this about how you lose control over your own economy. I think Dr. Prebisch, who has lived through it, can testify to it very much more effectively than I can.

But the basic statement is that, if you are relying upon foreigners to fund your banks and if you are relying upon foreigners to take your paper, then if the foreigners say, gee, I own enough American CD's and, I hope, enough U.S. Treasury obligations and I don't want any more of those, then the question of how you persuade them to keep doing, to keep providing you with the drugs upon which you have become dependent becomes a very, very difficult political question, and by no means unrelated to the sort of experience that the Argentines and some of the other Latins are going through now.

Chairman LAFALCE. Dr. Prebisch, would you care to comment on this specific point?

Mr. PREBISCH. Yes. I agree with Mr. Mayer. I think you are in very bad company. [Laughter.]

Chairman LAFALCE. You are not speaking of Mr. Mayer in your company. [Laughter.]

All right, very good.

Mr. Mayer, on pages 7 and 8, you said that the governments of developed countries should alter some of their regulations on loan loss reserves. Well, how much difference would that make in practice? How much are banks already putting aside, and how much do you think they should be putting aside?

Mr. MAYER. They are now putting aside more. They should be putting aside more than they are. If one were to sit here and really advise people, which I am not in the business of doing, there has to be some participation in these losses by the governments of the developed countries, by this Government, and by the governments of the other group of 10 countries.

Some of this should be for the purpose of enabling the banks to reduce their interest charges and to stretch out repayments. I think that Dr. Prebisch is absolutely right that it will be looked upon by future historians with amazement that these relatively minor steps were not taken.

But it is important for the Government to some extent to urge the banks into this situation to cushion. These institutions are, for other reasons and long-term systemic problems, the banks. They are taking loan loss reserves now from profits that have been made in the most dangerous imaginable way, because what you see is that every time the cost of their funds goes down, they do not give the benefit of that declining cost to the borrowers, and they show increased profits for quarters when interest rates are going down.

What you also see is that the best borrowers no longer borrow from the banks. They borrow in the commercial paper market where they can get the advantage of declining rates. So the banks reach out for more and more risky borrowers and get themselves

into more and more perilous conditions at the same time that their monopoly of the payment system is being taken away from them by technology, and the average cost of their funds is rising asymptotically to the average cost of funds of other lenders. So that they are in over a 20-year period a very, very serious systemic problem.

I do not believe that they can carry the major share of the burden. I do not believe that the Latin debtors, or certainly not the African debtors, can carry the share of the problem that they are being asked to carry.

So that one has to begin scrambling around for ways that the governments, and this one particularly with its appalling deficit problem, can make contributions to reducing the burden on the Latin countries without trying to compel the banks to pay more than some fraction of it, because they probably can't.

What is important, it seems to me, is that we reduce the notion that it is all going to work out all right, and we begin to look around for how we can take some of the burdens off, and Argentina probably less than the others. The Argentine people don't suffer the way the Peruvians and Bolivian people suffer.

But certainly for those countries where the income of the average inhabitant is below a certain level, for God's sake, let's help these people. We have to do a chunk of it governmentally—some of it should be done by enabling the banks to exact easier terms, and some of it should be done directly, but we can't take the governments out.

I have here this very modest suggestion, that to help the banks get into a situation where they can, in fact, bear some of these losses as they come around; they should be encouraged to accumulate loan loss reserves by having the portion of the income that is dedicated to loan loss reserves removed from their taxable income.

The Internal Revenue Service has now reduced to six-tenths of 1 percent the proportion of assets that banks can have in their loan loss reserves and still add to those reserves from pretax income. This is folly.

On the other hand, as I said in the testimony, the regulators by insisting that loan loss reserve is part of capital, which no second-year accounting student would permit, are making it very difficult for the IRS or for the Congress to go to more sensible policies. One thing that should be done, however, is to change that to get the banks on a somewhat more solid stand.

Chairman LAFALCE. Those are some suggestions very worthy of pursuit, and I think we will pursue them.

One last question before I turn to the other members of the subcommittee. You mentioned the problem of capital flight from some Third World countries, and the World Bank has estimated between 1979 and 1982, Argentina had capital inflows of \$30 billion and a capital flight of \$19 billion, almost two-thirds.

Likewise, almost half of the \$55 billion of foreign capital entering Mexico was taken immediately out again by Mexicans.

What is the significance of this capital flight? What can be done to coax some of it back, and I ask that of all of you gentlemen.

Mr. MAYER. Let the others talk for a while. [Laughter.]

Chairman LAFALCE. Well, Dr. Prebisch or Mr. Tucker, do you share that concern?

Mr. PREBISCH. I share that concern, and I am ashamed to say what my country did in this matter in the past. They took measures to stimulate the outflow of resources, and that part of our debt is in the hands of the Argentinians in New York.

Chairman LAFALCE. Primarily the military, correct?

Mr. PREBISCH. Yes, sir. Now the problem could be solved if there were some alleviation of banking secrecy in this country as well as—

Chairman LAFALCE. Some alleviation of the what?

Mr. PREBISCH. The banking secrecy.

Chairman LAFALCE. Change our Bank Secrecy Act?

Mr. PREBISCH. If Argentina could know the names of all Argentinians that have deposits in New York or houses in Miami, we could take measures, very equitable measures to—

Chairman LAFALCE. Has Alfonsin requested that the United States consider changing its Bank Secrecy Act in order to enable him to—

Mr. PREBISCH. Well, that could be one of the best recommendations of yours, Mr. Chairman.

Chairman LAFALCE. All right, we will pursue that. As a matter of fact, I was an author of many of the amendments to the Bank Secrecy Act in 1978, and maybe we could revisit that issue.

Mr. PREBISCH. Nothing would be more just to Argentina, to get them to bring back these resources.

Chairman LAFALCE. Mr. Tucker.

Mr. TUCKER. Well, I agree with what both of my colleagues have said. I would like to qualify that, however. It is, yes, one side of the problem that the Argentines and other people who have the money want to push it out of their countries and put it in a safer place.

The other problem is that there is a safer place, that in effect interest rates in the United States are so high in real terms that it is much more profitable for somebody to invest the money in the United States than to invest it in their own economy. As long as interest rates are so different between countries on that level, there is an overwhelming economic incentive, as well as any political incentives there may be, to move the money out of the country.

So one way of alleviating it also is to bring down real interest rates in the United States, and that is again one of the major problems of why we have this ballooning inflow of capital.

And I think perhaps the one thing that wasn't mentioned by Dr. Feldstein and Dr. Bergsten at your hearing on this inflow of capital is the fact that this did happen in the 1920's and that it didn't happen for very long, that it became so unsupportable and people had so much money in the United States that they began to question whether or not it was safe here. Our economy looked like it was on the brink of changing. Interest rates seemed to be about ready to fall drastically and people began pulling out their money. The capital flight was unstoppable and no central banker at that point could stop it.

This rapid outflow of money was one of the reasons why the stock market fell in 1929.

Chairman LAFALCE. On this issue, what happened in 1929? Could you expand upon that comment in writing to the subcommittee?

Mr. TUCKER. I would be willing to.

[The following expanded comments from Mr. Tucker were subsequently received:]

August 29, 1985

As requested by Mr. LaFalce, chairman of the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance, and Urban Affairs, I hereby submit in writing my expanded comments on a point which was raised during the July 25, 1985 hearing on the impact of Third World debt on the U.S. economy. The issue raised at that time was the relevance of interest rates and capital flows to the 1929 economic downturn in the United States.

I am happy to provide any further assistance.

Sincerely,


Stuart E. Tucker
Fellow

Capital Flows and the 1929 Crash

The relevance of interest rates and capital flows to the 1929 economic downturn in the United States is of interest because the current debt problems of the Third World in some ways harken back to the events of the late 1920s. At that time, the international financial system was burdened by two kinds of financial debts. First, the Versailles Treaty ending the First World War had required that Germany make reparations payments for the damage caused by the war. At the same time, France and Britain had borrowed money mainly from the United States to finance their war effort. Second, the fall of primary product prices on world markets had caused a number of other countries to become debtor countries to maintain consumption levels.

Thus, in the last half of the 1920s, the United States and to some extent Britain were the creditors for a number of countries borrowing heavily on international markets. As with the Third World today, there was a serious question as to whether Germany and other debtor countries had the capacity to pay back this debt. This problem in the 1920s was on two levels. First, these countries had to find ways of producing more than they consumed. Secondly, there was the problem of transferring real resources to the creditors. While there is some debate as to whether Germany had the capacity to pay the reparations bill, there is no doubt that the United States and France were unwilling to run the trade deficits necessary to receive the resources from Germany.

The situation became so precarious, that eventually the creditor nations had to agree to ease the annual payments burden and to lend debtors the money

necessary to keep them from sliding into recession. (Ultimately, much of Germany's reparations debt was forgiven by decree in 1931--long after the payments had stopped and after the world had fallen into depression.) Thus, in 1928, much of the finance available internationally came from the United States and Britain.

It is in this context that the events of 1928-1929 in financial markets became so important. 1928 saw the U.S. experiencing high real interest rates as fiscal and monetary policy were very tight. This, along with an extraordinarily rapid boom of the U.S. stock market, helped suck in large amounts of foreign capital. As a result, international lending declined sharply in 1928. The scarcity of capital contributed to a crisis of confidence in Germany's ability to pay its debts in the Spring of 1929. International lending slowed. Because of the booming U.S. stock market, capital remained tied up in the United States instead of flowing to compensate for the contraction of lending by other countries. Thus, in 1928-1929 the position of debtor countries deteriorated, with many sliding into recession as the powerful deflationary effect of the capital contraction affected primary producer income.

The capital flow into the United States peaked in 1929 as investors became suspicious of the vitality of the U.S. economy. In August 1929, U.S. income peaked and began to fall (largely due to internal economic factors). Within three months, the stock market--buffeted by the dual attack of a sliding economy and the flight of international capital--crashed.

The recession in the United States then spread to other parts of the world while at the same time that Germany's recession brought down much of Europe.

With the world-wide downturn being synchronized, the depression of 1929-1933 became extraordinary in that it lasted longer than most previous depressions. With income and capital continuing to contract, United States banks were beset by a series of runs on their resources starting in October 1930. Within two and a half years, more than one-third of U.S. banks failed, as their short-run liabilities were called, while their assets were generally locked into longer-term investments.

* * * * *

The major lessons to extract from these capital flows are that:

- * the large flow of capital into the United States created financial problems overseas,
- * the capital inflow did not last very long,
- * the capital flow reversed as soon as there were signs that the U.S. economy might be slowing, and
- * the rapid capital outflow was a major factor contributing to the collapse of the stock market.

Notes: For a further description of these events in the context of the world economic situation, I refer you to the following works on this period of history: Kindleberger, C. P., The World in Depression, 1929-1932. Fearon, Peter, The Origins and Nature of the Great Slump, 1929-1932. Aldcroft, Derek H., From Versailles to Wall Street, 1919-29 (Especially, Chs. 8-11). Haberler, Gottfried. The World Economy, Money, and the Great Depression, 1919-39. Temin, P., Did Monetary Forces Cause the Great Depression? (The work of Temin, while controversial, provides some alternative points of view concerning the causes of the depression.)

Chairman LAFALCE. I would appreciate that very much. Thank you. Charles Kindleberger has written about it also.

Mr. PREBISCH. Yes, professor emeritus at MIT.

Chairman LAFALCE. Mr. Prebisch, do you care to comment on that last question I raised?

Mr. PREBISCH. I have a wicked thought, which is that the banks know who these people are. The banks have these accounts. The banks facilitated the flight of this money. If it appeared to the banks that it would make a difference in their ability to get their loans to places like Argentina serviced and they made some information available to the Argentines, their resistance to changes in the Bank Secrecy Act might diminish.

The problem is that they now can have it both ways. I read an op-ed piece in the Times actually reporting on a conversation I had with a man now in Miami who ran the Argentine end of one of the great American banks, and let's not identify him too closely. I talked to him about this round trip phenomenon, and he said to me sort of pittingly, "If you were Argentine, would you want your wealth, your children's future, denominated in pesos or in dollars?" I said in dollars, and but I wouldn't lend me money.

When they saw this happening, they had some obligation indeed to their own senior banks, they had some obligation to everyone involved, which they neglected. At this point in the game to ask them to assume that obligation by making available to the authorities in these countries some information about in whose hands that money is, if there were some threat involved in this, they might be a little less horrified than they would be if you just came to them and said it is a political matter and you should do it.

Chairman LAFALCE. Thank you very much. Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman.

I would like to welcome our guests to the hearing today, and I apologize for being late. I had to go to another meeting.

I have had an opportunity to at least review part of your testimony, Mr. Mayer, and have read your testimony, Mr. Tucker. I am just going to ask one question and ask each of you to answer, and we will start with you, Mr. Tucker.

The subject of these hearings is the impact of Third World debt on the U.S. economy, and let me just ask you to characterize very briefly how you would view the status now of the Third World debt situation. Is it serious, is it grave or is it all right, and what is the trend, is it improving, deteriorating or is it stable? And finally, what recommendations for action, if any, do you have for the Congress?

Mr. TUCKER. The point I would make to this question is that in a normal recovery from a worldwide recession a developing country on average would grow about 7 percent. In 1984, developing countries grew 3.7 percent. They are predicted to maybe grow 4.5 percent in 1985 by very optimistic estimates out of the IMF.

What we see is a very weak recovery. Therefore, there is something causing that, and the only thing that seems to be there is the debt. There is no other reason that you could say is causing such a significant slowdown.

Second, if you look at the debt, it has been rather large, despite numerous attempts over the last 2 years to affect the debt. If you

look at a graph of the growth of debt in the developing countries, there is not a dip anywhere. It just goes straight up, and there doesn't seem to be any change in that.

Part of that is because banks are no longer sovereign and they are being forced to lend back. Part of that, as governments recognize, is that it is good to keep these countries afloat, but the debt problem is not going to disappear and it is not going to become something that is a back page issue next year. It is always going to be with us if we don't find creative solutions. It is a serious problem.

Mr. CARPER. How does the Congress figure in those solutions, if at all?

Mr. TUCKER. Essentially the Congress figures in a number of realms. We have already talked about regulation. Unfortunately, if the situation becomes serious enough, it may require more direct intervention. I am not prepared to explain what is the best direct intervention. You should be having people from the Fed testifying on that subject.

But if direct intervention is necessary, it will be a drastic intervention. It will not be something that you slowly implement. We saw intervention against the rules of banking essentially in the case of Continental-Illinois. Other top 10 banks are running into problems similar to Continental-Illinois, and we can expect possibly that these may become bigger problems in the future.

The Congress can do the best thing by peripheral policies related to interest rates, and again the budget deficit keeps coming back at us, but more directly helping ease the banks into a coalition of bank and government personnel that manages the debt rather than see it simply as a commercial question.

Mr. CARPER. Thank you.

Mr. Mayer.

Mr. MAYER. I have no disagreement with any of that, except again for my feeling that if we get our house in order, and I know Mr. Tucker doesn't disagree with that, but if we get our house in order, it gets to be easier for other people to get their houses in order, too.

The debt situation looked better in 1984, it looks not quite so good today, and my hunch is it will look worse in 1986. There are always going to be rationalizations about why it is going to work, but the political burden, as Dr. Prebisch said, is being placed on these countries, I don't think can be carried forever.

And the fakery that is involved by banks carrying bad assets as good assets is bad for confidence in these institutions. It is bad for variability to do their proper job in this economy and it makes other troubles.

Now under direct loss of jobs, Mr. Tucker has done the work and I have not. I have a lot of anecdotal evidence, particularly from 1983 when the Mexican markets were very important to people who made spare parts from machinery and such things were absolutely closed off.

I suppose the paradigm is what has happened in Britain in their relations with Nigeria, which was a major customer of theirs, where the whole credit business has blown up. I don't think it can just be left to lie there. I think that there has been a window of

opportunity in 1984 and 1985 to get something constructive done on this which may not exist when you get to 1987 and that then you may have to have the kind of crash intervention, where we don't do terribly well.

Once again, I am not the person who would have the authority to speak about what should be done in detail. Again, the Fed has good people, and the State Department, oddly enough, has good people. They never used to have much say in the world, but that didn't mean that they weren't pretty good people. The Treasury Department used to boss them around, but under Mr. Regan they sort of lost that old elan that the Treasury used to have and they haven't gotten it back yet. So that there would be people who have lived with this on direct terms, and I think they would be much more competent than I.

My father used to like to tell the story about the centipede who had a foot ache and went to the owl. The owl said, if you had two feet like normal people it wouldn't hurt so much. The centipede was very pleased and came back the next day and said how do you do this, and the owl said, I just make policy. I am in that position and to some extent you are, too, of course.

But there are guys who have lived with this who are able people. I would say that the untapped resources probably in the Economics Bureau of the State Department which hasn't been used to being listened to, and there are lots of intelligent people that have been in these countries and lived with this thing that would be worth tapping. That, plus the Fed, and some of the people perhaps who have left the big banks and who have seen some of this coming, or somebody perhaps like Bill Ford who is now the president of First Nationwide Savings, who was the head of the Federal Reserve Bank in Atlanta, which had supervision over the Miami banks, a very, very smart, iconoclastic economist.

These people might have some new ideas that would be worth putting into this situation. I think we have pretty much ritual ideas at this table, or maybe not.

Mr. CARPER. Mr. Prebisch? Again let me restate my question. What I was looking for was a statement from each of you as to your perception of the gravity of the situation that confronts us now. Is it improving or deteriorating, is it stable, and what specific recommendations do you have for the Congress and what action should we take to affect that situation of Third World debt?

Mr. PREBISCH. I don't think, sir, that the situation has improved. On the contrary, it has become more and more serious.

I have said before that if there is no political action in this matter, negotiations between bankers and debtors would not be conducive to the solution of the problem. I think that it is necessary to change the maturity of the loans and mainly to reduce the rate of interest.

Mr. CARPER. Again, is that something that you expect Congress to mandate? I don't believe you do, do you?

Mr. PREBISCH. Sir, I think that this is a highly political problem. I don't think that the continuation of this emergency solution between bankers and debtors would solve the problem. There is no other way to establish a framework for continued negotiations.

I do not mean to say that governments have to negotiate, but to establish some principles, a certain framework inside which negotiations should continue.

Mr. CARPER. All right. Thank you all.

Chairman LAFALCE. Ms. Kaptur.

Ms. KAPTUR. Yes, Mr. Chairman, and thank you. I am sorry I wasn't here for your formal testimony, but I want you to know that I sat here and read it through some of the questioning. And, Mr. Mayer, I am certainly glad to meet you. I carry your little books around all the time trying to understand what is really happening in the banking industry.

Chairman LAFALCE. If I could just correct you, his big books. [Laughter.]

Ms. KAPTUR. Big books. Well, I buy the paperback version. [Laughter.]

Chairman LAFALCE. He does not write little books. He only writes big books. [Laughter.]

Ms. KAPTUR. And I want to commend the chairman for holding these hearings because it is amazing to me how the media has dropped this issue. Last year or a year and a half ago this was in the news all the time and now we don't hear about it. However, your judgment is that the situation has not improved, but is getting substantially worse.

It is interesting to me that a lot of the fine journalists we have in this country are missing this, and I think it is extremely important.

I have several questions, first in the area of definition. When we read Leonard Silk in the New York Times saying the United States is a debtor nation, how do each of you define what a debtor nation is. Do you all agree on what that means? What are the elements of that definition? When you read the sentence the United States has not been a debtor nation since 1914, what does that mean to you?

Mr. TUCKER. Well, I would somewhat disagree with that terminology, although we are moving toward becoming a debtor nation. There are two kinds of debtor nations, those that have contracted direct loans that they intend to be paying back and those that simply through their interest rates are pulling in a great deal of investment usually of a much more short-term nature. We are the latter case.

We are bringing in more capital than we are exporting and pretty soon we are going to have to send that money back, and in that sense we owe other countries their capital. That is short-term capital flows.

Ms. KAPTUR. Who do we owe? Do we owe the banks of those countries?

Mr. TUCKER. A variety of people. Usually the banks are the portfolio managers and they are simply finding the best place to invest money of the entrepreneurs of the world. So they are just mediaries, but, yes; it is usually the banks that are funneling the money into this country.

There are also, you know, a few rich people, where we're talking about an Arab who owns an estate in Los Angeles County or somewhere else. But it is basically a phenomenon of capital flows that we are seeing here rather than contracted debts that we could not

meet in other ways, which is the case that you have in Argentina where they don't have other sources of money.

Ms. KAPTUR. Does anyone agree or disagree with that distinction?

Mr. MAYER. I have certain disagreements. The Fed publishes every week a number, which is the U.S. Treasury papers that are held for a foreign official account. The last time I looked, that was getting up to \$140 billion.

Ms. KAPTUR. Would you just repeat that. The Fed publishes—

Mr. MAYER. The Federal Reserve every week publishes a number, and you can find it in the New York Times or the Wall Street Journal actually, which is the foreign holdings by foreign official bodies—foreign governments, foreign central banks, et cetera—of U.S. Treasury paper, which are held by the Fed for these countries. That number is roughly \$140 billion, which you will notice is somewhat larger than Brazil's and Argentina's debt put together.

Lots of people have foreign debts already. That is to some extent the tip of the iceberg. The world's currency reserves are held in dollars. They are held in U.S. Treasury paper. That is something that has grown upward since 1914 because we were not a debtor nation, and the people were willing to hold the security for their own currency to a large extent.

We had this fight with General de Gaulle in the 1960's who thought the dollar was a bad investment and he wanted gold. We, at that point, had the gold to back the dollar. But there is a certain amount of the dollars that are out there, and they are there because the facilitated national trade and because, if you are an Italian selling to the Dutch, it is most easy to do it in dollars rather than go through the business of lira and guilder. Some are national holdings to back their own currencies, but there is a certain amount that is long-term investment.

Mr. McNamar, shortly before the trap door was dropped beneath him, was saying that the Europeans were so smart they were buying all these unoccupied Houston office buildings at bargain prices. The Kuwaitis bought up Atlanta in 1975 and we all laughed at them. It turned out, by God, they were right. It may turn out that the Europeans are right again that they are making the sort of investments that they are making now. Both the portfolio investments and the direct investments are very intelligent things for them to be doing.

Ms. KAPTUR. Would you put these types of foreign investment in the second category that Mr. Tucker identified? Which is that our interest rates or investment opportunities here are pulling in capital?

Mr. MAYER. There is an economic argument, and there is also, of course, a political argument that this appears to be a stable place for rich people to have money, and, indeed, for corporations to make investments.

But there is a netting out process here as a result of two great wars, which we entered later than others, and as the result of our own freedom from that sort of disruption. We had an accumulation through this century of American investment abroad which was our creditor position.

We have now managed in the space of a very few years to dissipate that.

Ms. KAPTUR. Now I have read that definition. I have been trying in my own mind to separate out these ideas, and I have read that debtor status is based on the fact that there is more investment in the United States now than U.S. investment abroad.

Mr. MAYER. That used to pay for a lot of oil, that net investment abroad that we had. We had a services account.

Ms. KAPTUR. But what is that investment abroad? Is that investment abroad in securities of other countries? Is it in oil wells?

Mr. MAYER. A lot of it was in mineral resources, some of which was nationalized and some of which is still there. A lot of it is IBM all over the world manufacturing. General Motors owns Opel, and Ford is in Britain and Germany, and in Argentina and in Brazil.

Ms. KAPTUR. Well, I guess Mr. Tucker would argue the fact that this has now become a negative for the United States. That there is more investment coming in than going out, and that interest rates would be the causal factor. This fits in with the fact that the United States isn't investing abroad.

Mr. MAYER. Interest rate short term. We have got a lot of long-term stuff going on.

Ms. KAPTUR. You were talking about the political.

Mr. MAYER. And there is also political.

Ms. KAPTUR. Mr. Prebisch, would you agree with the distinction that Mr. Tucker has drawn here on international debt of the United States—

Mr. PREBISCH. A little louder, Madam, if you please.

Ms. KAPTUR. Do you agree with Mr. Tucker that there are two categories of debtor nations and that when the United States is defined as currently a debtor nation, that definition applies to the second category? When I asked what was the definition of the United States as a debtor nation, did you hear his statement that there are two kinds of debtor nations? The first kind are those nations that have contracted direct loans that must be repaid, like Argentina. The second kind are those nations that, through their interest rates, are pulling in capital flows from abroad. He put the United States in the second category.

Mr. Mayer then tried to quantify the official foreign holdings of U.S. Treasury paper. He used a figure from the Federal Reserve, \$140 billion.

Do you want to add anything to their definition or comments?

Mr. PREBISCH. No, Madam. I think that this has clarified my own thinking in these matters.

Ms. KAPTUR. All right.

Mr. Chairman, will you bear with me, and may I ask one more question?

Chairman LAFALCE. One more question.

Ms. KAPTUR. If you were giving a speech, if you held our positions and you were giving a speech to the people of your district, in view of the situation that you know exists with our deficit, our trade deficit and our Government deficit here, the Federal Government deficit, if they asked you the question well, what should we invest in if we want to be good citizens, what would you recommend we do with our money? Do you even recommend that we

save any more? What would you recommend to the average citizen of the United States in view of the situation that you know exists? If they want to help, what would they do, buy U.S. Government debt securities?

Mr. TUCKER. Are you asking me?

Ms. KAPTUR. All of you.

Mr. MAYER. Do you want me to do this one first?

Mr. TUCKER. I have been going first before. Why don't you go first on this one.

Mr. MAYER. OK. If you want to give an honest answer, you ought to say to the American people that you have been pigs in recent years, and we have got to stop. [Laughter.]

We have been living on other people's production and we have been consuming more than we produce. We tell everybody else in the world that they have to reduce their standard of living to pay their debts. In this country we talk about tax reform which is going to reduce people's taxes at a time when we have a \$200 billion deficit. I mean there is a snorting of hogs that goes on this country which is distasteful to the rest of the world. You can't say this to your constituents because you won't get reelected, which is a large portion of our problem.

But in general, yes, people have to save more. There was a phrase that was common in the 1970's that is now gone, but it is a very important phrase and it is a pity that it is gone, which is the marginal propensity to consume imported products. Now everybody has gone beyond that and is talking about the strong dollar and all the reasons why we have more imports than exports.

There has been in this country rising now for a long time a concern about our own production. If you look at the television ads you will see Ford, and quality is job one, and the effort that has been made in the last few years by our producers for the first time in a long time to pull up their own socks and to talk about the quality of American products and to talk about doing things better here.

In part we have to do things better here. The attitude that the Japanese car is a better car is a terrible burden for our balance of payments to carry, and it is a terrible burden for our motor companies to carry, and to the extent that it is true, it is a real crisis.

All of these things have to be said, but at the bottom line they have to save more, they have got to consume less and the Government has to consume less. We simply cannot run deficits of this size without having many of the other things that are now happening happen.

Ms. KAPTUR. So you are actually asking them to put money in the bank?

Mr. MAYER. Yes, because the bank has a lot to do with it. They don't have to put it in the bank. It doesn't matter how they save it. It does matter a little if they save it by means of trading up houses—and there is an interesting piece in today's Wall Street Journal about Japanese and U.S. housing practices—if they figure that the way to build up their savings is to buy a bigger and better house and that is going to go up with inflation, that is not very useful savings.

But they can put it in the bank, and they put it in a mutual fund, and they can put it in U. S. Government paper, but in general the proportion of people's income in this country that goes into savings as against consumption had better rise. It had better rise or the trouble is going to be worse.

If you want to say that to your constituents, say it. Whether they will listen to you or not, I don't know.

Chairman LAFALCE. Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, I would like to follow on Ms. Kaptur's question to Mr. Mayer. Could you more clearly identify the snorting hogs in this respect? It is obviously not 240 million Americans.

Mr. MAYER. In a sense it is, you know. In a sense it is. Obviously, there are a lot of people down below who are struggling and trying to make it, but the general aim of this society has been a very short-term consumption-oriented aim now for a long time. You start to pay for it after a while.

We are relying on foreigners to provide the capital for our own investment, for the improvement of our own products, and for our own technological advance. We are relying on foreigners to provide the money that we won't tax ourselves to run a Government with a \$200 billion deficit.

A very high proportion of the country is involved in this, and not all by any means. There are people who do not benefit by this system, but there are a lot of people who do.

I wrote a long time ago, and I think all of us have said it at one time or another that we can't have as low a savings rate as we have. We can't have as much emphasis on consumption as against investment as we have got and have it work out right over a long period of time.

Mr. KANJORSKI. Well, if the Federal Government had not, as a matter of policy in 1981, reduced the income tax rate, wouldn't this have been a form of forced savings where we would take the funds out of the hands of industry and the people, and put it into the tax structure and not have a deficit?

Mr. MAYER. I have a somewhat different view of 1981. I think that what happened was that a tax bill that was arguable came to the Congress, and by the time that it left the Congress, it was a disgrace.

If we had merely gone with what the President proposed, and there are aspects of it that I wouldn't have liked, but you wouldn't have anything like the revenue consequences that we had by the time the White House gave up the store in order to get a victory. All of the lobbyists around here, speaking of the snorting of hogs, got their own little deals in. So the revenue loss from the final bill in 1981 was double what the President had proposed in the spring, and we are still trying to dig out from under it. If we had had just the income tax changes, it wouldn't have made that much difference.

It is also true that a great burden has been put on the lower-middle class and working class in this country over the years by the failure to raise the exemption at the beginning, the notion that it is \$600 and now it is \$500 right after the war is appalling.

But, in general, you have to raise the revenues to do what you want to do, and the failure of the Government to do that, either to raise sufficient revenues or to cut down its own expenditures enough lies at the root of a great deal of this and is one of the things that makes it all so unmanageable. I am sorry, but you have heard this from others. It is a bore now, but it is true.

Mr. KANJORSKI. To get off that subject just for a second and to clear my own mind, not being an economist, but as a young man I recall one of the major issues every 2 years in our national elections was the concept of foreign aid. Then somewhere in the 1960's somebody discovered that the Government didn't have to provide the foreign aid and the banks could.

Mr. MAYER. In the 1970's, yes.

Mr. KANJORSKI. Do you agree with that?

Mr. MAYER. In the 1970's.

Mr. KANJORSKI. Have we really removed it from a political issue by turning it over to the private sector, the banking community of America, and they turned out to be the Government to provide foreign aid at their election?

Mr. MAYER. That is very shorthand, but there is a sense in which that is true. But when the oil shock came, the governments were paralyzed by it, and they were watching the cobra rise. They really let the private sector handle it and, indeed, encouraged the private sector to do it.

Mr. KANJORSKI. Has anybody in the economic field done a study to indicate the proportion of Federal aid that this Government used to provide on a nation-to-nation basis and the purchasing power of the dollar value today that would be a portion of our budget and to see whether this offsets with the flow of loans from the private sector? Is there some relationship?

What I am getting at is if we are called on at sometime in the future to bail out the banks and to save the economy, are we going to be able to say well, we are really only putting up Federal dollars now where they should have been and the only sin that we have performed is to turn the direction and control of those loans over to the private sector who either misused or abused them, but it would have cost the Government the same amount of money over that 20-year period?

Mr. MAYER. I mean to bail out the banks is a stronger phrase than I would like to see. I think the banks have to take some losses. But if the losses are beyond the capacity of the banking system to withstand and the Government must do it, I think a very strong case can be made that the banks—and you can even, if you go back into the files, find memos of telephone conversations in which, in fact, people of authority in the U.S. Government encouraged the banks to go and do these things because nobody else was doing it.

Yes, I think that is an argument that could be made. I don't know whether others would agree with it.

Mr. TUCKER, do you want to respond?

Mr. TUCKER. Well, I think there is a sense in which foreign aid since World War II has drastically fallen as a percentage of our GNP. I think it would be foolish to say that if we went back to

those levels right after World War II that we could cover all the losses the banks would be taking.

The problem is essentially not that it was simply a grant from the banks, but they wanted interest. So this money they granted has actually grown as a liability. So we are not going to be able to pay it off directly with money that we could have been simply appropriating over the years. That is the problem.

Mr. KANJORSKI. I just have one final question for everyone, Mr. Chairman. Do we have any conflict constitutionally with reestablishing the interest rate on these foreign loans since they are private contracts? Is there any position on that? Do we really as a Congress have the authority to interfere with a private contract between a foreign national bank and a private bank?

Chairman LAFALCE. With great moral persuasion.

Mr. TUCKER. There is one point, and that is that the banks are discounting their loans and selling them to other people already and the Government could become one of the buyers. That is the easy way.

Chairman LAFALCE. Could we give tax incentives for longer maturities?

Mr. MAYER. There are various ways it could be done, obviously. The one that your constituents are least likely to find is the one that is most desirable from your point of view.

It is not in the interest of the U.S. Government to have the banks take the licking of the dimensions that maybe they deserve. It is not in the interest of the U.S. Government to have the borrowers take the licking that they are now taking. So both of those statements being made, then somebody has to find some way so the worst results can be avoided. It is very hard to do it quietly.

What Volcker did for Mexico at the beginning, which is as quiet as they could possibly make it, got very noisy within the first week. I think people are going to have to have a certain amount of guts and say look, we can't afford what the results are if we don't act. But I don't think that you can ask the Latin countries to squeeze themselves that much more.

I think what you can ask them to do is that if some of the burden is relieved, that they will do their utmost to repatriate the money that is out and that they will run their own economies in a very different way from the way that they ran them in the last 10 years. This is in their own self-interest, God knows, but if you have to take some heat from your constituents, they have to take some from theirs, too.

Chairman LAFALCE. Mr. Torres.

Mr. TORRES. Thank you, Mr. Chairman.

I apologize for having left the room momentarily. I had another commitment.

As the chairman knows, we traveled to Latin America in the first part of this year. He was not able to go all the way to Argentina with us. I and my other colleagues had substantial discussions with President Alfonsin over the particular Argentine issue, the question of the foreign debt.

I was appalled, as my other colleagues were, to learn that the flight of capital from Argentina is somewhere in the neighborhood of \$40 to \$50 billion. I think Mr. Mayer touched partly on that.

Dr. Prebisch, could you confirm that? Is it that high?

Mr. MAYER. Perhaps the figure is too high, maybe from \$25 to \$30 billion.

In addition to that, we have from \$2.5 billion to \$5 billion, according to different estimates, of actual dollars in the hands of Argentina, and this is disastrous. We cannot blame them for doing that because this is the result of the inflation in Argentina.

Mr. TORRES. The new policies of President Alfonsín, the economic policies, do you see them in any way repatriating some of this capital back to Argentina?

Mr. PREBISCH. I would encourage any sensible measures to expedite the repatriation, but as I said before, this depends largely on the cooperation of the American banks that are prevented to give information due to the secrecy of the banking operations. If that could be alleviated or removed, I think that we could, as Mr. Mayer said, find a way to stimulate the banks to this clause of secrecy.

Is that what you meant?

Mr. TORRES. Perhaps I am being redundant here or duplicative, Mr. Chairman, and please constrain me if someone asked this question in my absence, but I was interested in Dr. Prebisch's idea that he talked about in his statement about the possibility that debtor countries pay the full amount of the interest charges but transfer only part of it.

Could you elaborate a little bit on that?

Has that been asked?

Chairman LAFALCE. It hasn't, but I was going to ask it.

Mr. TORRES. Well, do it now then.

Mr. PREBISCH. Well, I have in mind naturally the case of Argentina, but this can be applied to other countries.

Mr. TORRES. To Peru as well?

Mr. PREBISCH. Well, the situation in Peru is much more serious. They need other types of measures to alleviate the situation. But fundamentally what I have in mind is the following.

I would not like to see governments not making the fiscal effort to mobilizing internal resources to pay. This is an internal problem that should be solved by our countries. What we cannot do is to transfer the full amount. Then let us mobilize resources and transfer a part of it, according to some arrangement made with the creditors, and deposit into a fund the part that has not been transferred and use that for investment purposes.

A bank having a part of this fund may negotiate with investors to be paid in dollars here and release the amount of blocked dollars in Argentina for investment purposes.

Am I clear, sir?

Mr. TORRES. Yes. Is there a precedent for this, or is this—

Mr. PREBISCH. Well, there are precedents in my imagination.

[Laughter.]

I don't think that there are precedents because this situation has no precedent at all. We have to use new ways of attacking the problem.

Mr. TORRES. Thank you, sir.

I yield back the balance of my time, Mr. Chairman.

Chairman LAFALCE. Thank you.

Let me follow up on a question that Mr. Torres asked. How would we work toward a system whereby the debtor countries would be able to transfer a part of their payment and their debt into a special fund that could be used for investment purposes in that country? Would this have to be on an ad hoc basis between the individual country and each and every individual bank that is a creditor, or is this something that can be done under the auspices of the U.S. Government, or under the IMF?

It sounds to me like a very good idea. There are dangers involved, and it could become a political football, but I think that you could prevent that. I think you could have the bank ensure that those investments would be for legitimate and productive purposes and give them the final authority.

But what steps do you take to lead toward that and who should take those steps?

Mr. PREBISCH. Well, sir, I think that this is again a highly political problem, and that governments should establish the basis, the principles and the norms for this operation, and inside this negotiations between banks and government should follow. But some principles have to be formulated in order to give the maximum seriousness to this.

Chairman LAFALCE. It seems to me that the United States is going to have to take the lead in something like that. I don't know that it is going to be done otherwise, which brings me to another problem.

Mr. Mayer, you made a statement, and I think I share your sentiments, but before I could be sure of that I would need you to expand upon them. When you said the State Department has a tremendous amount of expertise and knowledge and insight, et cetera, on these issues, although they have been called upon, but that the Treasury Department has lost its elan. What do you mean by that latter statement? Could it mean perhaps that the Treasury Department is almost anti-Third World country, or if not anti-Third World country, anti-multilateral financial institutions or against a strong United States' role in alleviating the problem of the Third World debt, et cetera?

Mr. MAYER. The Treasury Department always—

Chairman LAFALCE. Pardon?

Mr. MAYER. The Treasury Department always was of that mind, but it was strong.

Chairman LAFALCE. Under Miller and Bergsten?

Mr. MAYER. Yes. If you went and you talked to people under them, if you went and you talked to the permanent cadre of the upper civil servants of the Treasury Department, they were a very tough lot, but they were very strong and they really understood what they were talking about. They were pretty much cleaned out in the early years of this Administration.

And what was put in in their place doesn't have much authority. When I was writing my book about diplomats, I spent a lot of time at the State Department, at the Economics Bureau because I live in that world, and suddenly, I kept seeing some of them, and in about 1981 or 1982 they were like prisoners infidelio, they were coming out and seeing the sun for the first time and somebody was asking them what they thought.

The Under Secretary for Economic Affairs in the State Department is one of the great sort of hanging jobs that nobody knows what it is supposed to do that we have had in this country. When it was Douglas Dillon who held it, it was an important job.

Chairman LAFALCE. Who has it now?

Mr. MAYER. Alan Wallace, and you barely hear from him. I mean he is a statistician to begin with and—

Chairman LAFALCE. Oh, I hear he is the former chancellor of the University of Rochester.

Mr. MAYER. Oh, yes, he is an able man. I am not saying that—

Chairman LAFALCE. He is ultraconservative and someone who probably thinks that the Third World countries got into this problem and they should solve it themselves.

Mr. MAYER. He may, but I wouldn't want to speak for Alan Wallace. But the sort of political skills that Douglas Dillon had made that an important job.

Chairman LAFALCE. He is in State. He is not in Treasury.

Mr. MAYER. He is in State. I am saying that that job has always been a very unimportant job, but under that in the Economic Bureau, which reports directly to the Secretary and doesn't go through the Under Secretary for Economics Affairs, there is a whole bunch of able people who have lived in these countries who used to put through memos which would come to Treasury, and Treasury would bat them aside and nobody paid much attention to them.

Now I think they are beginning to feel that it is worth their while to produce some ideas because there is not that much between them and the policy-making people in the White House. They don't have to go through Treasury or anything like the same extent because Treasury gradually over the early 1980's began to diminish in the authenticity of its representations to the White House. And I would think that that would be a group that would really be worth—

Chairman LAFALCE. "To diminish the authenticity of its representation," now I am not sure what that means.

Mr. MAYER. In general the intellectual level of the Treasury Department sank very seriously. [Laughter.]

That is what that means.

Chairman LAFALCE. OK. That I understand. [Laughter.]

Mr. MAYER. I was trying not to say it quite that bluntly, but it is true. So I should think that this might be a good time for the Congress to see if it can't tap some of the expertise inside the State Department on this issue, because I don't think Treasury has the position now to stop it, which it would have had 7 or 8 years ago.

Chairman LAFALCE. Treasury doesn't have the position now to stop it. Stop what?

Mr. MAYER. The "IG" groups that litter the streets in this town.

Chairman LAFALCE. Stop what groups?

Mr. MAYER. The interagency groups or the intergovernmental groups, all of these things where the government decides what position it is going to take to the public and what position it is going to take to the Congress. In those that had to do with foreign economic affairs in the 1970's, the Treasury Department had by far the

greatest weight, and ideas that might come up from the State Department did not get to you. Today I think they might.

They are an elite group in many ways. They have lived in these countries and they have good economic training, a number of them, and they care about it, and they also care about this country. I should think it would be worth trying to tap them because I think that all of the forces that might have stopped you in the past, 10 years ago, are now much diminished and you might be able to get things out of them.

Chairman LAFALCE. Thank you very much.

We could go on, but unfortunately I am going to have to call today's hearing to a close.

But I want to thank you very much. I think this has been extremely interesting and extremely informative, and the entire subcommittee is most grateful to each and every one of you for that.

Thank you very much.

[Whereupon, at 11:35 a.m., the subcommittee adjourned, subject to the call of the Chair.]

[The following statement of Hon. Norman D. Shumway was subsequently received for inclusion in the record:]

Statement of the Honorable Norman D. Shumway
 Economic Stabilization Subcommittee Hearing on
 Effect of Third World Debt on the U.S. Economy

July 25, 1985

Thank you, Mr. Chairman. I join you in welcoming our distinguished panel of witnesses. Their testimony today will undoubtedly prove illuminating on the impact of the Third World Debt Crisis on the U.S. economy and economic competitiveness.

The LDC debt crisis and its ramifications on our international economic condition is a little discussed -- yet highly significant -- chapter in the catalogue of factors affecting our economic performance. Many of these countries have not been able to service the large debts they accumulated in the late 1970s, when inflation ran rampant. Moreover, their difficulty in servicing these debts was increased by the recession-triggered slowdown in growth and inflation in the industrial countries, as well as the rise of world interest rates.

It was only natural that these countries have embraced policies of austerity in an effort to increase exports and reduce imports, thus earning foreign exchange to pay their debts. But these efforts at austerity, together with the other factors, have not been without their consequences, particularly as our economy is concerned.

Our economy has taken a beating. A burgeoning federal budget deficit, high real interest rates, an overvalued dollar and the lack of LDC export markets have triggered our mammoth trade deficit. Private commercial capital has exited this country to fund the LDC debt. The result has been a weakening of certain sectors of our economy, such as manufacturing; an increase in our budget deficit, as revenues generated by exports have decreased; and an increase in our trade deficit, as export markets in the LDCs no longer exist.

The debt crisis has also provoked increased calls for protectionism -- both here and in the LDCs. I would suggest, however, that before we yield to this option, we should examine the role of the LDCs in terms of our economic needs and our trade policy.

The developing nations are not helpless bystanders in U.S. trade policy. On the contrary, by virtue of their debt crisis, they have become major participants in the policy process itself. Because of this inextricably tied relationship, we cannot -- indeed, should not -- sit idly by and sanguinely view the recent turns our trade policy has taken, particularly the new cries for protectionist measures.

I would reiterate what many of the previous witnesses testifying before this Subcommittee have said: trade barriers -- whether they are maintained by the U.S. or the developing countries -- are not the solution to either our current trade problems or the fiscal problems

of the LDCs. Indeed, they are self-defeating and contrary to the economic interests of both.

In the case of the LDCs, such measures favor production for home markets over production for export markets. This, in turn, promotes inflation by reducing competition and increasing the cost of imports, limits producer and consumer choices, encourages retaliation and retards liberalization in favor of the protecting country's own exports and reduces foreign exchange earnings used to purchase the country's own exports.

U.S. trade barriers against exports from developing countries reduce the efficiency of the U.S. economic machine. More importantly, they substantially reduce the purchase of U.S. exports and most recently, threaten the viability of the U.S. financial system by reducing the LDC's ability to service their debts.

However, there are macro and microeconomic policies the U.S. can pursue to ameliorate the debt crisis and our inordinate trade imbalance. First, we must reduce our fiscal deficit so that interest rates can be reduced. Each percentage point on interest saves the LDCs approximately \$4 billion in interest payments.

Second, these actions would also tend to reduce the dollar, which is currently overvalued by about 30%. We all know an overvalued dollar has caused serious difficulties for a developed country such as the U.S. However, it has caused greater problems for developing countries. Corrective depreciation of the dollar would sharply increase the dollar export earnings of the LDCs and alleviate the debt problem.

In short, the U.S. needs to get its own house in order before we take any other steps.

Beyond this, we must encourage further growth and development in these countries. This, in turn, will stimulate their ability to import our goods. Further efforts at negotiation to open LDC markets as well as continued funding of the debt will provide the necessary mechanisms.